EUROPEAN COMMISSION
Competition DG

Directorate D
Unit D 1 Financial services

Business insurance sector inquiry

Inquiry into the European business insurance sector pursuant to Article 17 of Regulation 1/2003

Interim report

January 2007

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I. EXECUTIVE SUMMARY

The Sector Inquiry into Business Insurance aims at analysing the provision of insurance products and services to businesses within the European Union. As stated in the Communication by Commissioner Kroes of June 2005, its main objective is to understand the functioning of the sector, which would ultimately allow to detect distortions of competition. Such distortions may then be tackled under Articles 81 or 82 of the Treaty, either by the Commission or by national competition authorities within the European Competition Network.

The preliminary findings of the Sector Inquiry, as described in the present Interim Report, are based on desk research as well as on a survey amongst insurance companies, insurance intermediaries and reinsurers, and national associations of insurers, intermediaries and risk managers. The survey amongst insurers and intermediaries, mainly brokers, was conducted using statistical sampling methods. The response rates of the various steps of the survey ranged between 80 % and 100 %.

The Sector Inquiry has examined the following areas:

- financial aspects of the business insurance sector;
- duration of contracts in the business insurance sector;
- reinsurance;
- structure, function and remuneration of distribution channels;
- horizontal cooperation among insurers.

1. FINANCIAL ASPECTS OF THE BUSINESS INSURANCE SECTOR

Results based on a standard profitability ratio, which is commonly used by the industry and provides a competitive benchmark, reveal that profitability is high in business insurance at the EU-25 level. Pre-tax profitability in business insurance was around 26 % across the three largest European insurance markets in 2005 with high variation both in terms of insurance lines and Member States. Underwriting profit ratios vary up to 200 % across the EU-25 for the same insurance line and up to 100% within the same country for different insurance lines. Profitability has also been sustained over time in most Member States but is significantly higher in the new Member States than in the EU-15.

The cost bases of insurance companies vary considerably across the EU-25 and are not converging. In particular, insurers in the new Member States display consistently higher cost ratios than those in the EU-15. It thus seems that at Member State level, less efficient markets also display higher profitability.

The extent of variation in profitability indicates an important degree of market fragmentation and the potential scale for price reduction in several Member States.

High and sustained profitability in some Member States may be the result of the exercise of market power. Further investigation will focus on possible causality between financial performances and possible barriers to competition in some markets.

Finally, it is worth noting that some Member States tend to display consistently higher underwriting profitability in segments of small and medium-sized enterprises (SMEs) than in segments of large corporate clients (LCCs). This might indicate that in these Member States, underwriting for SMEs is used to cross-subsidise low returns in the LCCs' segment.

2. DURATION OF CONTRACTS IN THE BUSINESS INSURANCE SECTOR

The inquiry's data show that the average duration of insurance contracts for a given line varies substantially between Member States. While in many Member States the majority of the insurance contracts are concluded on an annual basis, long-term agreements are common practice in some other Member States, such as Austria, Italy, the Netherlands and Slovenia.

Moreover, clauses allowing for the automatic renewal or extension of contracts are common.

The data do not show a substantial difference between practices concerning LCCs and practices concerning SMEs.

In certain cases, the duration of the insurance coverage offered by a contract is an essential characteristic of the product that is defined and marketed by the insurance company. As long as duration of coverage is inherent to product definition, it seems doubtful that it could be seen as a restriction of competition. However, when this is not the case, long-term agreements in the business insurance sector can, under certain circumstances, raise competition concerns related to the risk of foreclosure of the insurance markets to new entrants.

The assessment of the foreclosure effects of long-term agreements will notably depend on the cumulative effect that networks of similar long-term contracts will have on access to the market. It will also depend on the appraisal of other factors pertaining to the economic and legal context of the agreement. These factors are related, on one side, to the possibilities for a new competitor to penetrate the bundle of contracts and, on the other, to the conditions under which competitive forces operate on the relevant market. Finally, 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 the similar contracts found on that market.

Further investigation will assess the likelihood of these risks of foreclosure.

3. REINSURANCE

A substantial number of the world's major reinsurers are established in the European Union. They write business on an international basis as reinsurance itself is predominantly an international business.

The European Commission’s practice in the field of merger assessment has considered that the provision of reinsurance should be regarded as a single relevant product market covering the provision of reinsurance for all classes of risk, as a reinsurer covering risks of a particular class may readily and quickly switch capital and resources from that class of cover to a different class of cover (supply-side substitutability).

The results of the Sector Inquiry show that 91 % of insurers take into account financial ratings when selecting reinsurers and that 95 % of these insurers have defined a minimum rating below which they would not consider buying reinsurance from any reinsurer. This raises the question of the demand-side substitutability of the different reinsurers and thus whether ratings may affect in specific cases the definition of the product market.

Furthermore, in the case of a decrease in the ratings of a considerable number of reinsurers, the question arises whether the insurers would maintain their ratings expectations, as this would lead to a situation where only a limited number of reinsurers would be able to provide cover to most insurers.

The inquiry also shows that reinsurance companies active in the EU include the so-called "best terms and conditions" clause in their contracts with their clients, the direct insurers. This clause allows a given reinsurer to benefit from any more favourable terms that could have been agreed between the same direct insurer and another reinsurer within the same reinsurance arrangement. This “best terms and conditions” clause can appear in treaty as well as in facultative reinsurance. It is drafted in different ways, and sometimes introduced even via a stamp.

The “best terms and conditions” clause harmonises terms and conditions at the most favourable level for the reinsurers concerned, irrespective of the characteristics of these reinsurers, to the detriment of the direct insurer and, ultimately, of the final business insurance customer. The clause also increases price transparency and, under certain market conditions, could amount to a restriction of competition within the meaning of Article 81(1) EC. Some respondents, however, advanced arguments in order to justify the practice.

4. STRUCTURE, FUNCTION AND REMUNERATION OF DISTRIBUTION CHANNELS

Business insurance products are distributed through a variety of channels, whether directly by insurance companies or indirectly through exclusive (or tied) agents, multiple (or independent) agents, brokers, banks or other financial institutions.

The ***structure*** of distribution channels varies from one Member State to another due to historical and cultural reasons, but differences also exist according to the insurance lines and/or client profiles concerned. Although many insurance companies operate through more than one distribution channel, 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.

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 that do not have their own or a sufficiently developed distribution network. According to the survey of insurers, access to distribution infrastructure is among the most important factors influencing insurers’ decision to enter a new market.

The ***function*** of brokers has changed over the last twenty years. It has developed from the traditional role of market-matchers, whose services relate to the transfer of risk from clients to insurers, to the role of service providers to clients and to insurers. An increasing consolidation and concentration of the brokerage markets has contributed to increasing size and resources of brokers. Furthermore, improvements in technologies have prompted brokers to offer a variety of additional and innovative services to their clients.

The results of the sector inquiry suggest that although brokers deal on average with a large number of insurers, in general they concentrate a large proportion of their business with a very small number of them.

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 could be a source of conflict of interest between the objectivity of the advice they provide to their clients and their own commercial considerations.

Amongst the factors that determine which particular insurer a broker recommends to his clients, the price quoted for the transaction, the insurer's financial standing and the breadth of risk coverage available rank first. The importance of these factors varies little whether the client is an LCC or an SME, anywhere in the EU. However, LCCs appear to be generally better informed by their brokers than SMEs. Despite marked variations between Member States in the number of quotations and different insurers’ terms that form the basis of brokers’ advice to their clients, this number tends to increase in accordance with the complexity of the risk to be insured. The larger the risks, the better advised are the clients.

The function of independent intermediaries, in particular brokers, in stimulating competition in the insurance market place could be weakened not only in case of conflicts of interest related to their dual role mentioned above, but also in case of conflicts of interest related to their ***remuneration.*** Such conflicts of interest may compromise the objectivity of the advice given to clients.

In this context, contingent commissions received particular attention due to the so-called "Spitzer" investigation conducted in 2004 and 2005 in the United States that involved the world's largest insurance broking firms and several insurance companies. Contingent commissions are payments made by insurers to intermediaries, based on the achievement of agreed targets. They could thus create incentives for intermediaries to steer, for instance, high volume or profitable business to selected insurance companies. This might not necessarily be in the interest of clients.

The results of the Sector Inquiry confirm that contingent commission agreements were widespread in many Member States in the past, particularly in the EU-15. Some intermediaries have derived considerable revenues from contingent commissions, highlighting the potential for conflicts of interest. It appears that the investigation in the US and the increased public attention have led some market participants to change their policy concerning contingent commission agreements, but not necessarily to abandon all contingent commissions. Other market participants have made no changes to their practices. The Commission intends to further examine this issue.

As confirmed during the Sector Inquiry by the risk managers' associations, insurance clients are critical of the lack of transparency of intermediaries' remuneration. The survey shows that intermediaries across the EU tend not to declare to their clients spontaneously how they are remunerated for the placement of insurance through commissions. With the exception of Denmark, Finland and Sweden, in the Member States surveyed, respondents disclose their commissions spontaneously only to between 3% and 30% of their clients. The corresponding figures stated by respondents concerning the disclosure of remuneration upon clients' request is considerably higher. However, there may be some doubts as to the reliability of these figures, as a number of respondents explained that clients allegedly do not request this kind of information. In the case of commissions, the insurance premium paid by the insured consists of the price of obtaining risk coverage as well as of the price of the mediation services, as both are bundled together. The overall lack of transparency of intermediaries' remuneration reduces the potential for price competition in relation to mediation services. The inquiry will examine this issue further, actively seeking the views of business insurance clients.

Prohibition of commission rebating by insurers could amount to resale price maintenance and could therefore constitute a restriction of competition which would not benefit from the block exemption granted by the Regulation on vertical agreements and concerted practices (Regulation (EC) No 2790/1999 of 22 December 1999). Commission rebating is still legally prohibited in Germany. The Commission will further examine to which extent commission rebating takes place and whether or not there are agreements or practices that would prevent intermediaries from rebating commissions to broking clients.

5. HORIZONTAL COOPERATION AMONG INSURERS

Horizontal cooperation among insurers varies widely amongst the various Member States and from one insurance line to another.

Some forms of cooperation are block-exempted by Regulation (EC) No 358/2003, adopted on 27 February 2003 and expiring on 31 March 2010. This Regulation grants a block exemption to agreements concerning calculations and studies, standard policy conditions, the joint coverage of risks and safety devices.

In particular, the survey shows that cooperation on ***calculations and studies*** is substantial in Germany and Belgium and, as far as insurance lines are concerned, for Motor, Property/Business Interruption, Environmental Liabilities, Personal Accident/Medical Expenses and General Liability. However, such cooperation seems much less important in Member States such as Hungary, Denmark and Poland. It is also much less substantial for the Directors' and Officers' Liability and for the Credit and Suretyship insurance lines.

Some associations stated in their replies that they do not always make calculations and studies available to non-member insurance companies.

Agreements concerning the joint establishment and distribution of ***standard policy conditions***, according to the results of the Sector Inquiry, are common in the industry, concerning practically all insurance lines, and more substantially the Property/Business interruption and the General Liabilities lines. However, this form of cooperation seems insignificant in the Czech Republic and in Poland, and marginal in Spain, Greece and Ireland.

While the majority of the associations indicated that their standard policy conditions are neither binding nor recommended, some stated that they recommend their standard policy conditions. One association even indicated that its standard policy conditions are binding. Moreover, a few associations do not make standard policy conditions available to all interested parties.

The Sector Inquiry also examined ***premium indexation clauses***. These clauses are a particular type of standard policy conditions which, in case of contracts concluded for more than one year or in case of extension or renewal of an existing contract, stipulate a premium adjustment, related to the application of a certain index. Replies from insurers to the Sector Inquiry indicate that 28 % of respondents use premium indexation clauses. This average figure however hides the fact that the use of such clauses differs widely between the various insurance lines and from one Member State to another.

It seems that insurers use mainly premium indexation clauses that they have developed on their own. Just under half of the respondents indicated, however, that they use indexation clauses developed by insurers' associations. According to the data collected from the insurers' associations, approximately half a dozen associations have developed premium indexation clauses, mainly in the Property/Business Interruption insurance line.

Data collected from insurance companies show that ***pools*** covering the territory of a single Member State are numerous for Property risks, as well as for General Liability, Motor and Professional Indemnity risks. This form of cooperation is particularly substantial in Germany, the Netherlands, Belgium, Finland and the UK. It seems less relevant in Italy, the Baltic Member States, Hungary, Slovenia and Poland.

Insurers associations seem to have been only moderately involved in pools. Their involvement has generally related to various aspects of the pool activities, including management and coordination of the pool, management of data exchange systems between the members of the pool and clearing and settlement of premiums and claims.

Cooperation on ***technical specifications, rules or codes of practice concerning safety equipments*** does not seem to have a substantial impact on insurers' policies in a large number of Member States (Cyprus, Denmark, Estonia, Ireland, Italy, Lithuania, Luxembourg, Latvia, Malta, Poland, Portugal, Slovenia and Slovakia). Conversely, it seems to play a role in particular in Austria, Belgium, Germany, Finland, France, the Netherlands, Sweden and in the UK. Such cooperation concerns mainly the Property/Business Interruption, the Transportation and the Motor insurance lines. It appears to be marginal in the Aviation and in all the Liability insurance lines.

Claims settlement agreements are common in Germany, in the Netherlands, in Austria and in Portugal as far as the Motor insurance line is concerned, and in France, in particular for the Motor and for the Property/Business Interruption insurance lines. This form of cooperation is, however, less substantial in a large number of Member States: Czech Republic, Estonia, Finland, Hungary, Lithuania, Luxembourg, Malta, Poland, Slovenia and Slovakia, as well as Italy, Ireland and the UK, as far as Property/Business Interruption and General Liability are concerned.

Finally, the Sector Inquiry established that insurers associations rarely charge insurers for ***access to data*** used to calculate risk premium.

On the basis of the differences between the various Member States that, according to the survey, appear as far as the level of cooperation among insurers is concerned, one could raise doubts about the justifications of such cooperation and about the scope of the exemption granted by the present Block Exemption Regulation. The public consultation on the present Interim Report should be an occasion for an open and fruitful debate on this issue.

6. CONCLUSIONS AND NEXT STEPS

The Sector Inquiry allowed the creation of a very comprehensive database on the five issues discussed above. However, due to the complexity of the questionnaires sent to the various market operators and to the significant efforts that data gathering meant, in particular for insurers and intermediaries of medium/small size, replies were not always as clear, accurate and exhaustive as expected.

The Commission intends therefore to conduct an additional targeted round of investigative steps (questionnaires and/or interviews) with various stakeholders. In particular, the Commission will concentrate these further investigations on concrete issues raising competition concerns. These supplementary investigations will not only contribute to clarifying certain issues that have emerged from the replies received so far; they will also sharpen the competition focus of the Sector Inquiry into Business Insurance.

Moreover, the Commission will pro-actively involve the customer side of business insurance (i.e. SMEs and LCCs) via their associations in the further progress of the inquiry, in order to be able to present in a Final Report a balanced view of the issues at stake.

With the publication of the present Interim Report, the Commission launches a public consultation, creating the conditions for an open and fruitful debate on the various issues raised in the Report. The public consultation period will end on 10 April 2007.

On 9 February 2007, a public Hearing will take place in Brussels with the participation of all stakeholders: insurance companies, intermediaries, insurers and intermediaries associations, regulators and associations representing business insurance customers.

The Final Report of the Sector Inquiry, which will present the findings of the new round of investigative steps and comment on relevant issues raised during the public consultation and the Hearing, will be published in September 2007.

II. INTRODUCTION

1. BACKGROUND AND AIMS OF THE INQUIRY

The Commission of the European Communities, having regard to the Treaty establishing the European Communities and to 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 Council Regulation (EC) No 1/2003, decided on 13 June 2005 to initiate an inquiry into the business insurance sector[1], relating to the provision of insurance products and services to businesses in the Community.

The decision took into account indications that in certain areas of insurance to businesses, distortive forms of cooperation may take place between insurers and that certain arrangements for distribution of insurance products and services to businesses may give rise to competition concerns.[2] The sector inquiry aims at fully understanding the functioning of the sector with a view to ultimately identifying any concrete restrictive practices or distortions of competition that can be addressed under Articles 81 or 82 of the Treaty, either by the Commission or by national competition authorities within the European Competition Network.

The purpose of this report is to present interim findings of the Commission's sector inquiry, inviting interested parties to submit their comments and observations.

2. METHODOLOGY AND DATA

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.

The dataset has been collected and assembled by DG Competition and the European Commission's Joint Research Centre (JRC). The final database was submitted to statistical tests in order to identify possible "outliers" (i.e., extreme observations) that could bias the analysis. Figures diverging significantly from the mean of the overall and country samples were thus identified.

Moreover, some respondents did not provide data on all questions of the questionnaire. The alleged reasons for failing to provide full answers related to technical limitations and the data reporting model that would make it impossible to provide data with the required detail. Consequently, a high response rate for the overall questionnaire does not necessarily imply that all questions were addressed in an equal and full manner.

A more detailed explanation of the methodology used, including the desk research and the analysis of the aforementioned surveys, is provided below.

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1 Please note that the term "business insurance" does not exist in EU insurance regulation. It has been defined.for the purpose of this inquiry as the provision of insurance products and services to any type of business, irrespective of its size, form of organisation or legal structure.

2 For details please see: (1) Commission Decision (EC) of 13/06/2005 initiating an inquiry into the business insurance sector pursuant to Article 17 of Council Regulation (EC) No 1/2003, and (2) Communication by Commissioner Kroes in agreement with Commissioner Mc Creevy, Memorandum on sector inquiries in financial services (retail banking and business insurance), both published on the European Commission's internet web-site: http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/

2.1 Desk research

Data and information was obtained from a wide range of published sources, including public bodies, private organisations and academic literature on insurance.

Major sources included, first, a variety of international bodies devoted to insurance matters or providing data on insurance. These bodies included, but were not limited to, the Organisation for Economic Co-operation and Development (OECD), the Comité Européen des Assurances (CEA), the European Federation of Insurance Intermediaries (BIPAR), and the International Association of Insurance Supervisors (IAIS).

Data was also obtained from bodies operating at the level of the individual Member States, including national supervisory authorities, the national insurance associations of the 25 EU Member States (representing insurance companies) and national associations representing various types of insurance intermediaries.

Further data was gathered from reports and other publications produced by a large number of individual insurance firms and commercial organisations supplying insurance-related information. Among these, the reports in the *sigma* series produced by Swiss Re Economic Research and Consulting and the non-life Insurance Market Reports produced by Axco Information Services were found to be especially helpful.

Finally, as noted above, the academic literature on insurance and insurance markets was consulted.

2.1.1 Limitations on data derived from desk research

The usefulness of the data obtained from desk research was subject to a number of limiting factors.

Firstly, the Sector Inquiry is concerned only with business (commercial) insurance and 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. For example, data on insurance usually distinguishes between life insurance and non-life insurance (or general 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 consumer segments within business insurance (for example, between insurance premiums relating to small and medium-sized enterprises (SME) and premiums relating to large corporate clients.

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. However, reporting entities, whether public or private, rarely adopt precisely the same classification. This can make it difficult to verify data by cross-checking it against information from another source. It can also be difficult to make valid international comparisons when classification systems differ between Member States.

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.

2.2 Surveys

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.

2.2.1 Surveys of associations

An initial survey was conducted among 27 national insurance associations in all the Member States of the European Union, 38 intermediaries associations in 22 Member States and 12 risk management associations 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 (see below). There was considerable variation in the depth and detail of the information provided by the respondents in this survey.

Insurance associations were requested to provide precise information on their membership and on activities they pursue, in relation to as well as outside of the field of application of Regulation (EC) No 358/2003 of 27 February 2003 ("Insurance Block Exemption Regulation").

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 covered also claims settlement agreements.

2.2.2 Surveys of insurance companies and insurance brokers

A survey 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.

2.2.2.1 Sampling for the insurer survey

For the insurer survey the sample consisted of approximately 250 insurance firms from the 25 Member States. The sample was drawn from lists of insurers provided by national insurance associations in some cases and from a variety of databases in cases where the national insurance association did not provide sufficiently detailed information. The sampling was then carried out on a country basis, because a purely random survey of EU insurance firms would have led to the under-representation of some EU countries in the sample, particularly the smaller countries.

The number of addressees in the sample for each EU Member State was based broadly on the size of each national insurance market, measured in terms of its premium volumes. This proportionality principle could not be applied in a simple arithmetic way (since premium volumes in the largest EU insurance market are 700 times greater than in the smallest), so a compromise was reached whereby the sample was formed according to a scale ranging from 25 firms in the largest EU non-life insurance markets (Germany and the UK) to five firms in the smallest.

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. To achieve this, a listing was obtained or constructed of all non-life insurers active in each EU Member State, or in the case of the very large markets, a list of all players other than those with insignificant market shares. Chosen from these lists, the sample for each Member State always included some of the largest firms whose estimated cumulative market share accounted for 50% of non-life premium volumes in the country concerned. Since concentration in EU non-life insurance markets is relatively high, it was always possible to capture companies accounting for this 50% within the constraints of the sample size. A random selection was then applied to the remaining firms on each national list. In each case they were divided into three groups according to the 33 and 67 percentiles based on non-life market share. From each group an (as far as possible) equal number was randomly selected, with the total equal to the number for the whole sample for the country, less the number of firms in the initial selection of firms accounting for 50% of the market. Moreover, respondents were requested to include the corresponding data of subsidiaries in the same Member State, further increasing the market share represented by the sample drawn from the listing.

Critique

The main drawbacks of the sampling technique used are that large insurers are over-represented, which diminishes the criterion of equal representation of insurers of different size in the sample. In addition insurers in the smaller Member States are over-represented and hence the significance of features peculiar to these states is likely to be exaggerated.

However, this bias was felt to be justified by the need to ensure that the largest players in each country were included, not least because competition problems may be more likely to arise in connection with firms that have a large market share, and competition problems in connection with large firms are likely to a have a greater impact on consumers than those associated with small ones.

Equally, it was deemed important to provide adequate coverage of all Member States, including the smallest ones. A number of the latter are new and emerging markets where there has been only limited competition in the past

2.2.2.2 Sampling for the intermediary survey

The survey consisted of 164 intermediaries from 14 Member States. The limitation of the number of Member States was due to practical necessities. However, the sample included respondents from the EU-15 and EU-10 Member States and covered (in terms of insurance premiums placed in these Member States) the major part of the EU market.

The list of the EU Member States subject of the survey is as follows:

EU-15: Belgium, Germany, Denmark, Spain, Finland, France, Italy, Netherlands, Portugal, Sweden, United Kingdom;

EU-10: Estonia, Hungary and Poland.

The sampling process for the intermediary survey presented greater problems than that for the insurer survey. The first problem lay in choosing the types of intermediary to include (e.g. insurance brokers, insurance agents, banks etc.). Including a range of these in the same non-segregated survey would clearly create significant difficulties. For example, the answers to some questions (for example on relationships with insurers) would necessarily produce different responses from different types of intermediaries which could not be compared properly. Information provided by, for instance, exclusive agents would be of limited value owing to the fact that reasonable representation would require a very large sample size. Moreover, the questionnaires sent to insurers covered a number of aspects relevant for the analysis of distribution channels characterised by a higher proximity of insurer and intermediary.

The sample and survey generally was therefore confined 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.

In constructing the sample it was assured that more than half of the Member States were taken into account including the ones with the highest insurance premiums placed.

Regarding the selection of the sample the problem emerged that, whereas figures are available for non-life premium volumes and market shares of insurance companies in all EU Member States, there are no equivalent figures for insurance intermediaries in the vast majority of Member States. In a few Member States figures are available for the revenues of insurance intermediaries and in other cases there are some figures on employee numbers, but there is no comprehensive data for the EU as a whole. This meant that the ranking of intermediaries in the national lists from which the samples were taken was necessarily less precise than the ranking in the insurer survey.

Subject to these constraints the sampling process for the intermediary survey followed the same principles employed for the insurer survey.

Critique

Most of the main weaknesses in the sampling technique for the intermediary survey have already been identified and, the reasons for the restriction of the survey to independent intermediaries have been set out above. It was felt that a good picture of the activities of non-independent intermediaries could be gained from the insurer questionnaires. Therefore, the latter were structured so as to elicit information on the use and activity of non-independent agents.

2.2.3 Survey of reinsurers

In addition to the surveys mentioned above, a survey of 11 reinsurers was carried out, based on a short questionnaire (17 questions). This questionnaire concerned mainly 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).

Reinsurers were selected on the basis of the list of the biggest worldwide reinsurers (in terms of non-life reinsurance premium written). 11 of these reinsurers that had EU headquarters and that did not write mainly intra-group reinsurance (where insurers are part of the group) were chosen. The sample included some Lloyd’s market participants.

III. THE NATURE AND FUNCTION OF BUSINESS INSURANCE

Business Insurance intends to serve the insurance needs of a business rather than the needs of an individual, i.e. it provides protection of an insured's business or profession. Business insurance is essential to many companies, as it helps companies to protect the pursuit of their operations from major property and liability risks.

Although we focussed our research as well as our questionnaires in our surveys on “business insurance” as compared to “personal insurance”, it should be noted that the distinction is not always easy to achieve. When it comes to very small businesses or “one person companies”, many insurers may underwrite the “business risks” of these clients – tools of their trade, vehicles, etc. – as personal insurance. Equally, some small traders may try to avoid business insurance and rely entirely on any personal insurance they might hold.

From a regulatory perspective, it shall be noted that insurance sector, similar to the banking sector, is an area in which EU harmonisation has reached a substantial level. An internal market for insurance services and products has been established through the three generations of Life and Non-life insurance directives[3], five directives concerning third party motor liability insurance[4], the recently adopted Reinsurance Directive[5] and a number of directives dealing with specific insurance-related matters.[6]

The EU Directives take their regulatory starting point in the legal entity, i.e. the insurance undertaking, and hence, provides the same rules regardless of whether the policyholder is a company or a natural person. Hence, the term "business insurance" as used in this Report does not exist in the EU insurance legislation. However, the non-life insurance Directives do contain the concept of so-called "large risks"[7] and foresee some special rules in this regard. As far as insurance contracts related to large risks are concerned, the contracting parties are free to choose the law applicable to the contract.[8] Moreover, the pre-contractual information requirements prescribed by the Third Non-life Insurance Directive do not apply in case of policyholders who are not natural persons.[9]

1. Classification of business insurance

There are various ways of classifying business insurance, including the following

- Classification by consumer segment (type of buyer)
- Classification according to subject matter or risk insured
- Classification for licensing and regulatory purposes.

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3 For Non-life: Directives 73/239/EEC, 88/357/EEC and 92/49/EEC. The corresponding Life Assurance directives have been consolidated in Directive 2002/83/EC.

4 Directives 72/166/EEC, 84/5/EEC, 90/232/EEC, 2004/26/EC, 2005/14/EC.

5 Directive 2005/68/EC.

6 Directives on Coinsurance (1978), Tourist Assistance (1984), Credit and Suretyship (1987) Legal Expenses (1987), Insurance Company Accounts (1991), Supplementary supervision of insurance groups (1998), Compulsory Winding-up of Insurance Companies (2001), Insurance Mediation (2002).

7 See Article 5d of Directive 73/239/EEC as amended by Article 5 of Directive 88/357/EEC.

8 Article 7 (f) of Directive 88/357/EEC.

9 Article 31 (2) of Directive 92/49/EEC.

1.1 Classification by consumer segment (type of buyer)

Insurers' way of doing business, in terms of their product design, pricing, underwriting and distribution methods has come to be influenced more by the type of consumer involved than the risk insured. Insurers, therefore, increasingly classify their insurance products not only according to risk but also according to consumer segment.

In effect there are two main business insurance consumer segments:

1. Small business risks and those that form part of a homogenous class
2. Large business risks and those not forming part of a homogenous class.

1.1.1 Small/homogenous business risks

Small business risks are often treated by insurers as having more in common with personal lines than with large business risks. If the risks to be insured are simple and of a standard nature, insurers can 'commoditise' the insurance product and make savings in marketing and administration costs by using distribution channels and pricing and underwriting strategies that are similar to those used for personal lines.

It is, however, not only homogeneity but also the size of the risk that allows commoditisation. If an insurance company can insure all of the property and/or liability risks of a business without the need for co-insurance, then it is much easier to provide a commoditised product.

While insurance companies can write standard 'package' insurance contracts for business risks with characteristics that vary only a little (for example, most retail shops, restaurants, bars etc.) it is less easy to do so for business sectors in which risk characteristics are subject to wide variation, even among small businesses.

Furthermore, one should not forget that small/homogenous risks can be very complex. However, where buyers – especially smaller companies – cannot afford to specialise risk management, they need simple, clear and easy-to-understand insurances. They therefore might end up buying standardised and potentially unsuitable insurance policies and simplistic solutions.

1.1.2 Large business risks and business risks not forming part of a homogenous class

Large business risks are often complex and unique in their characteristics; a 'tailor-made' insurance programme is therefore often necessary. Large companies, who are the main clients seeking cover for large risks, are also able and willing to pay for specialised risk management, and thus get a more specialised product which best meets the specific insurance needs. The insured (or its adviser) is thus likely to exercise much greater selectivity as to the terms or coverage, limits and deductibles.

Insurance may be combined with other forms of risk transfer, e.g. securitisation or other alternative risk transfer ('ART') structures and, in the case of an international business, may have to be co-ordinated across more than one insurance market under an international programme. For this reason, insurance for large business risks are more likely to be arranged through a professional insurance broker and more likely to require specialist underwriting skills on the part of the insurer, together with various other specialised services. Although risks may still be bundled to some extent, separate contracts are often issued for different lines[10] and placed with different insurers, possibly in different markets.

[10] For example, large international corporations tend to place their property and liability insurance programmes separately.

1.2. Classification by subject matter or risk insured

Business insurance can be provided through a number of separate contracts, covering particular forms of property and/or risks and placed with either one or several insurers. Alternatively, and especially for small businesses, the insurance is combined in one contract and placed with a single insurer. In the latter case the insurance can either be a ‘combined’ policy or a ‘package’ policy. A combined insurance divides into a number of sections that provide different forms of cover, but the insured has quite wide discretion as to which covers to take up and as to the coverage limits for various sections, which are usually priced separately by the insurer. A package insurance provides integrated coverage with little discretion on the part of the insured to select or reject individual covers or to vary individual limits. The contract is usually priced as a whole, rather than section by section.

Whatever form the contract takes, and however it is administered, the subject matter of business insurance will comprise some or all of the following:

(a) some form of physical property which is exposed to the risk of loss or material damage and in which the insured has an interest;

(b) a potential financial or pecuniary loss;

(c) a potential legal liability, on the part of the insured, to pay compensation to another person.

Each category is discussed in turn.

1.2.1 Material damage (or property) insurance

These insurances cover some form of tangible property and compensate the insured for loss or physical damage. The property in question may be goods, buildings, crops growing on land or any other material thing. The policy may cover a particular peril only (such as fire) or a number of specified perils. Alternatively, the contract may be written on an ‘all risks’ basis. In this case the insurance covers loss or damage caused by any means other than perils which are specifically excluded (a number of perils are commonly regarded as uninsurable and an ‘all risks’ insurance will always exclude some forms of loss, despite the name). Instead of describing the risks which are covered, the 'all risks' insurance simply specifies those which are not.

At present, there seems to be a tendency in some Member States to write commercial property insurance on an ‘all risks’ basis, but the older ‘named perils’ approach is still quite common.

1.2.2 Financial loss (or pecuniary) insurances

When property is damaged, further financial loss may be incurred, beyond the cost of restoring the property itself. For example, if commercial or industrial premises are seriously damaged by fire, production may cease or reduce significantly for a period of time, resulting in loss of profit for the proprietor. This potential financial loss can be insured and, although it is a direct consequence of material damage, it can be treated as a separate class of insurance (known as loss of profits, or business interruption insurance).

Other types of pecuniary insurance exist to cover financial losses that do not result from any material damage to the insured’s property. Credit insurance, for instance, covers losses arising from bad debts of the insured’s customers who have become insolvent or have defaulted on their obligations. Alternatively, the insured may suffer financial loss or incur heavy expenditure as a result of his being drawn unexpectedly into litigation. Legal expenses insurance is available to meet this contingency.

1.2.3 Liability insurances

Firms or individuals who wrongfully cause harm to others, either by injuring them or damaging their property, may become liable in law to pay compensation for the losses which they have inflicted. The earliest forms of liability insurance mainly covered liability arising from industrial activity, trade and transport, and responded to accidents involving injury to people or damage to property. They grew to include liability arising from the sale of products and services that resulted in bodily injury or damage to property. More recently liability insurance products have been developed to cover financial loss arising from professional negligence or mismanagement. They include professional indemnity insurance, directors and officers insurance (‘D&O’) and various other specialised lines.

1.3 Classification for licensing and regulatory purposes

In the EU, as in other insurance markets, insurers must apply to the appropriate regulatory authority for a licence (or authorisation) before they may start to do business. Once authorised, insurers are subject to ongoing supervision. They must submit regular and detailed reports to the authorities so that the latter may be satisfied, among other things, that each insurer is maintaining a sufficient margin of solvency.

Insurers are not given a comprehensive licence to write all lines of insurance. In the EU they must apply for a license to write specific classes or groups of classes of insurance falling within two broad divisions: ‘life’ assurance business and ‘non-life’ insurance business. According to the EU insurance directives[11], there are seven individual classes within the former and eighteen classes within the latter category.[12]

Insurers are subject to a number of reporting obligations: they must regularly submit to the competent supervisory authority a breakdown of premiums, claims etc. for the various classes of insurance they underwrite. These reporting classes are often based around the authorisation classes described above, but are not necessarily identical: Furthermore, these reporting classes are not necessarily common across EU Member States, although work is on-going among EU supervisory authorities to streamline these reporting obligations.

1.4 Classification adopted in the sector enquiry

Although the broad categories of insurance outlined above exist in all EU national insurance markets, there are differences in detail when it comes to classification, particularly in relation to classification for reporting purposes, as discussed above.

For the purpose of this sector inquiry, a “traditional” classification was used. In the questionnaires sent to various insurance market participants, respondents were asked to provide information about their insurance activities in relation to various lines of insurance and

[11] Directive 2002/83/EC concerning life assurance; Directive 73/239/EEC concerning non-life insurance.

[12] The classes of life assurance business are: I Life and annuity, II Marriage and birth, III Linked long-term, IV Permanent health, V Tontines, VI Capital redemption, VII Group pension fund management (Annex I to Directive 2002/83/EC concerning life assurance). The classes of Non-Life insurance business are: 1 Accident 2 Sickness, 3 Land vehicles 4 Railway rolling stock, 5 Aircraft, 6 Ships, 7 Goods in transit, 8 Fire and natural forces, 9 Damage to property, 10 Motor vehicle liability, 11 Aircraft liability, 12 Liability for ships, 13 General liability, 14 Credit, 15 Suretyship, 16 Miscellaneous financial loss, 17 Legal expenses, 18 (Tourist) Assistance (Annex A to the First Non-Life Insurance Directive 73/239/EEC). In general, EU law does not allow a single insurer to be licensed both for life and non-life classes. However, Member States may still have derogated from this prohibition provided that they complied with the strict conditions laid down in Articles 18 and 19 of the Life Assurance Directive 2002/83/EC: each activity has to be managed separately and life and non-life companies within the same group are not allowed to co-mingle their funds.

consumer segments. The classification used in these questionnaires was also retained when drafting this report.

The lines of insurance were classified as follows[13]:

- Property/Business Interruption
- MAT:
  - Marine
  - Aviation
  - Transportation
- Motor
- Liability
  - General Liabilities
  - Professional Indemnity/E&O
  - Environmental Liabilities
  - Directors' and Officers' Liability
- Personal Accident/Medical Expenses
- Credit and Suretyship
- Residual Packages

The consumer segments examined were:

- Small and Medium-sized Enterprises (SME)
- Large Corporate Clients

For the purpose of the enquiry, the definition adopted for SMEs was any company whose staff number is below 250 people and whose turnover is under 50 million EUR. 'Micro-companies' were thus also included in the SME category.

2. The function and benefits of business insurance

Insurance is a risk-spreading mechanism that allows buyers of insurance to transfer some of the risks associated with their business activities to insurance companies. In doing so, they exchange the uncertain cost of large potential future losses for the reasonably certain cost of the insurance premiums they pay. To create this security for consumers, insurers transfer to them some of the benefits of their ability to diversify risk by building a large portfolio of insurance consumers (the law of large numbers) so that the premiums charged are less than most risk-averse consumers are willing to pay. In this way consumer welfare is enhanced.

The core concept of insurance - and the same is true also for business insurance – is therefore that the losses of the few are paid for from the pockets of the many. However, the aim of insurance is not to eliminate all risk, which would eliminate also all reward. The aim is to eliminate a degree of risk – common risks that are not core to the fundamental business or investment risk. Once the threat of fire or theft is taken care of by insurance coverage, the manager of a business can focus on the actual business risk: whether there is a market for the product, or whether the pricing is right.

Also, with adequate liability coverage, there is assurance for employees and customers that they will not be "left in the rain" if something goes wrong (e.g. bankruptcy, asbestos, etc.). This may influence their choice to work for or buy goods or services from this company, and thus influences the company's success. However, one needs to bear in mind that coverage such as employers' liability are included in the social security framework of a number of Member States.

[13] See the Glossary for the definitions of these lines.

Individual consumers also benefit from a wide variety of ancillary risk-related services that insurance firms (including intermediaries and claims-handling firms) are able to offer. These include advice on safety and loss prevention, the mitigation of losses when they occur and legal advice and support in dealing with compensation claims that might be made against them.

The risk transfer and risk spreading mechanisms provided by insurance companies can be viewed in terms of the efficient use of capital. Business firms would need to hold and retain more precautionary capital to safeguard their enterprises if there were no insurance markets to absorb risk. Thus, in effect, insurance companies supply contingent equity capital to industrial and commercial enterprises. This means that across the economy as a whole less equity capital is needed to support commercial activity.

3. Demand and supply factors in business insurance

In this section we consider the factors that govern the demand and supply of insurance and also the ways in which insurance volumes and insurance activity can be measured and compared in different markets.

3.1 The demand for insurance

In the broadest sense, the demand for insurance in a given territory appears to be largely a function of wealth (personal and in terms of business assets) in the country concerned. In poor societies insurance spending is low, as there is both relatively little wealth in the form of property and other assets to protect by means of insurance and little money to spend on insurance.

The demand for business insurance depends on a number of factors other than the degree of economic activity and economic growth in a given market. These include:

- changes in the structure of the economy in a given market – this can reduce the demand for some types of insurance and/or increase it for others. For example, the change from centralised economic planning to market economies in the – now – 10 new Member States has clearly changed the need for insurance in these countries. Less dramatically, the switch from a manufacturing to a service economy may bring about a reduction in the demand for industrial property and engineering insurance but increase the demand for professional indemnity insurance;
- the extent of compulsion to insure, which may be imposed at government level or through the demands of trade or professional bodies, or the requirements of business partners;
- the influence of government in terms of taxation policy affecting insurance and also social security policy, where a diminution in state provision (e.g. of workers' compensation benefits or health care) may stimulate increased demand for privately-insured alternatives, or vice-versa;
- social values and attitudes.

There seems to exist few close substitutes for business insurance. Risk prevention and risk assumption ('self-insurance') are not close substitutes as they do not involve risk transfer. Alternative risk transfer (ART) devices (such as catastrophe bonds) are not complete substitutes or realistic options for small firms. Again, businesses insurance premiums do not usually form a high proportion of total costs, and even when they do (as in the case of firms whose business involves high-risk activities) the effects of compulsion and the lack of substitutes may make it difficult to economise on insurance costs.

However, large firms whose absolute expenditure on insurance is high may have more scope for reducing their reliance on insurance because of their greater ability to self-insure or use planned risk assumption. The tendency of large firms to do so is certainly a factor in the relatively slow growth in general insurance spending in recent years.

3.2 The supply of insurance

The supply of insurance is mainly dependent on the ability to return a profit – after all, insurers are undertakings who only offer to underwrite insurance contracts if there is potential for making profit[14]. In particular, financial capital seems to be the main determinant of the supply of insurance.

Apart from the insurers' ability to assess risks and probabilities and their necessary know-how to develop products that have the potential to be profitable, a number of restraining factors determine the ability of an insurance market to supply insurance, including:

- regulatory and legal restrictions;
- the ability to pool risk exposures;
- adequate information to price insurance contracts;
- an acceptable level of moral hazard;
- the financial capacity to absorb very large losses.

3.2.1 Regulatory and legal restraints

National legislation or regulation may directly or indirectly limit or hinder the development of new and innovative insurance products. In some cases, official refusal to sanction a particular form of insurance may be based on considerations of "general good", for instance the reluctance to allow kidnap and ransom insurance or insurance against the financial consequences of losing a driving licence. However, economic and social change and product innovation do influence the regulators in their appreciation of what is deemed to be best in public interest. For example, liability insurance – insurance against the financial consequences of negligence – was widely held to be contrary to the public interest in the early nineteenth century but is universally accepted now.

Insurance contracts are subject to a number of legal criteria, which differ between Member States. However, some of those requirements are generally recognised. Hence, policyholders are only allowed to insure things or events in respect of which they may suffer a financial loss (the principle of insurable interest) and they should not be able to profit through insurance if the agreed insured event should occur (the principle of indemnity). For insurance markets to work there must also be a predictable legal system in which insurance contracts can be enforced and insurance disputes resolved.

3.2.2 The ability to pool risk exposures

Insurance is founded on the pooling of a large number of risk exposures, with the assumption that not all the contributors to the pool, or even a large number of them, will be struck at once. However, this assumption will hold good only where the potential causes of loss are largely independent of each other. This is the application of the law of large numbers, or portfolio diversification. If the risks in the pool are small in number but very large in size, and/or where there is a high degree of correlation between risk exposures, due to a potential common and simultaneous cause of loss, then insurance is less effective as a risk transfer mechanism. Catastrophic losses can either comprise one very large loss (such as the destruction of the World Trade Centre building) or, more commonly, arise from the accumulation of a large number of smaller losses from one event (such as the devastation of New Orleans that resulted from

[14] The profitability of the European business insurance market is examined in Chapter VI.

Hurricane Katrina). Failure to have an effective pooling of risk exposures does not necessarily mean that insurance cannot be supplied, but it does mean that the cost of insurance will tend to be high, because more capital will be needed to absorb these greater concentrations of risk.

When insurers or reinsurers provide insurance on low frequency/high severity risks (such as flood), they expect to spread losses not just across a portfolio of risk exposures at a point in time but also to spread them over time.

3.2.3 Adequate information to price insurance contracts

The ability of insurers to price risk depends on a number of conditions. First, the causes of loss or forms of damage that will trigger an insurance payment must be clearly defined in the insurance contract. Second, insurers must have sufficient information to estimate the probable frequency and severity of loss from the set of defined causes in order to determine prices. Third, consumers must not be allowed to conceal from the insurer, either willingly or unwillingly, information about their propensity to suffer loss. If they do so this will prevent the insurer from charging actuarially accurate prices, leading to adverse selection.

Adverse selection is predominantly a problem whereby “bad risks” are underwritten either on the basis of incorrect assumptions or where there is fraud or non-disclosure by clients. It is a major risk of entry into new markets or new segments, where new entrants can be taken advantage of by brokers and/or clients.

Accurate pricing is also necessary to reduce moral hazard, which is discussed next.

3.2.4 Acceptable level of moral hazard

Moral hazard is a problem that affects insurance generally: it is the risk that, by giving insurance cover, the insurer will bring about a change in human behaviour which makes the adverse and economically undesirable insured event more likely to happen. For example, insured persons may become less careful or even cause losses deliberately in order to get the insurance money. Moral hazard is thus to a large extent also the risk of fraud, but it has been noticed that insurance can indeed change risk awareness and risk aversion.

To discourage this, insurers generally seek to restrict cover to losses which are ‘fortuitous’ (accidental) and restrict payments to an indemnity only – i.e. exact compensation for the loss and no more. Moral hazard can be reduced by a number of standard techniques. These include the exposing of the insured to part of the risk by means of deductibles or coinsurance, the use of policy conditions to restrict coverage for high risk insured, either in advance of losses occurring or as a consequence of claims experience, and the levying of variable premiums according to risk.

However, if moral hazard is significant and cannot be controlled, or cannot be predicted and factored into the prices charged in the market, insurers may be unwilling to provide an adequate supply of insurance.

3.2.5 Adequacy of financial resources

The financial resources of the insurance market are enormous: the size of the global non-life market was over EUR 1.1 trillion in 2005. These resources derive from the capital and reserves held by insurers and reinsurers and the amount of new capital that they can raise quickly, plus part of the short-term cash flow from new business (since after a very large loss, insurance prices tend to rise sharply for a period of time).

Because loss exposures and loss concentrations have tended to become larger over time (for example, simply as a result of the continuous accumulation of valuable property over finite land areas) insurers and risk managers have sought to increase the capacity and flexibility of the insurance market over time. Most recently this has been achieved by tapping the capital markets to supplement insurance and reinsurance capacity through alternative risk transfer (ART) instruments such as 'Catastrophe' bonds.

4. Methods of pricing and underwriting business insurance

Historically, insurers have not always been entirely free to set the price of the insurance contracts they issue, or to bargain freely with their customers over price. In some EU Member States governments exerted considerable control over the price of insurance, setting minimum prices and/or maximum prices or fixed price scales for particular classes of insurance or, indeed, for all of them. This was justified on public interest grounds, to ensure that insurance prices were adequate but not excessive or excessively discriminatory. At the same time, groups of insurers collaborated quite extensively in exchanging information to price risks and, in some cases, agreed standard policy wordings and scales of charges (‘tariffs’) by which all members of these insurer groups would abide when dealing with customers. While some of these practices still exist outside the EU, within it they have been severely curtailed. The right of Member States’ authorities to exercise control over insurance policy terms has been effectively removed[15]. At the same time, competition law sets clear limits to cooperation among insurers.[16]

Generally speaking, insurance companies in the EU are now free to write insurance on any terms they agree with their policyholders provided they have the funds to set up the necessary actuarial reserves against their liabilities to protect shareholders and satisfy solvency regulations. As a starting point, insurance supervisory authorities do not monitor premium prices and policy conditions, but the over-all financial position of the insurance undertaking and its compliance with prudential regulation.

4.1 Pricing methods

Insurers generally employ two main methods for setting insurance prices. These are class (or group) rating and experience rating.

4.1.1 Class rating

Class rating is the method used for the majority of business insurance risks and almost exclusively for relatively small ones. Since the probability of loss varies from one risk to another, insurers seek to divide the total population of risks into a number of sub-classes or groups, placing risks of a similar type in the same group and charging the same rates of premium.

The factors which are most likely to influence annual claims cost are used to distinguish one group from another. These are known as rating (or underwriting) factors. The basic rate of premium for a given group or class of risk is based, at least in theory, on the average claims frequency for risks in that group and the present value of average claim size for such risks.

The techniques that are used to analyse data will depend on the level of detail and reliability of the data available, and also the extent to which the data are a good predictor for the future. In the case of some lines of business insurance the data is usually rather limited in scope, but in other lines, such as motor insurance, there are often large amounts of data down to a very fine level of detail.

[15] See Chapter IV, Section 2.1 for a discussion of this aspect of deregulation.

[16] See Chapter X.

4.1.2 Experience rating

Essentially, experience rating is the pricing of a risk on the basis of the policyholder's own past claims experience, or rating a risk on its own merits. Here it is assumed that the policyholder's own past claims experience can provide a statistical base that is wide enough to predict future loss patterns with reasonable accuracy. For example, experience rating can be used effectively for motor fleet risks (where there are a large number of vehicles under one ownership) and non-proportional reinsurance risks (for example, excess of loss treaties).

Large liability risks can also be experience rated. For example, in the case of a corporation with a large number of employees, accident statistics and claims experience for the last few years should provide a reasonably accurate prediction of future accident levels, allowing the workers' compensation or employers' liability risk to be based on experience rating.

Experience rating's use is limited in a number of ways. In particular, it cannot be used effectively for small risks, because the claims data for such risks often has little statistical significance.

Experience rating may not be practical even for large risks if they are of the type that generates long-tail claims, such as liability insurance claims for pollution or industrial disease. In this case, the level of claims being paid at any given point in time may not be a true reflection of the 'riskiness' of the business at that time, but rather only an indication of the riskiness of the business in the past – perhaps as long as thirty or forty years ago – when the claims being paid today had their origin.

In practice, insurers often use a combination of class and experience rating, rather than just one or the other. The no-claims discount (NCD) or bonus-malus system, used by motor insurers in many countries, provides a good example. Here experience rating is used to modify subsequently a premium that is initially set by the class method described above. Policyholders that do not claim enjoy a discount on the 'standard' premium, with the discount accumulated to a maximum that is retained as long as the policyholder's record remains claims-free, but reduced if claims are made.

Similarly, insurers often modify the 'standard' rate that they would otherwise apply to a business risk in the light of the insured's own claims experience and any other relevant factors peculiar to the client, applying a loading or discount as appropriate. Insurance pricing then becomes an initial process of *classification* ('what general class does this risk fall into?) and *discrimination* (is it a good risk of its type or a poor one?).

4.2 Other factors affecting the price of insurance

The price of insurance will depend on the cost of meeting expected claims for a given risk, based - in the case of class rating - on the average claims frequency and present value of average claim size for risks in that group, together with the cost of handling those claims. This will produce a sum know as the 'risk premium'. However, the final cost of the insurance will depend on a number of other, additional factors. They include:

- the level of deductible (excess) taken by individual policyholders;
- the cost of reinsurance that is purchased by insurers;
- loadings applied by insurers for contingencies (uncertain future events or trends);
- expense loadings (e.g. for business acquisition costs, renewal expenses, claims handling costs and general overheads);
- investment income generated by the funds that insurers hold, and hence interest rates and equity values;
- the cost of the capital that supports the business.

It is also well understood that insurance cycles arising from market forces and market behaviour exert a powerful effect on the price of insurance at any given time. This is considered next.

4.3 The underwriting cycle

The term ‘underwriting cycle’ (or insurance cycle) describes a distinct pattern of upward and downward movements in insurance prices in non-life markets, broadly cyclical in nature, and their subsequent impact on underwriting profitability, which is similarly cyclical.

Cyclical patterns, typically running over a period of six to nine years (peak to peak) tend to be especially pronounced in insurance markets. One commonly held view in studies of the insurance cycle is that while both the demand for and supply of insurance varies over time, it is variations in supply that are the more important. Financial capital is the main determinant of the supply of insurance and new financial capital can come into a market quickly to increase supply when premiums are high, and also can withdraw quickly from the market if investors feel that the rate of return received is falling below a satisfactory level. Similarly, and subject to regulatory approval, new insurance firms can enter an insurance market quite quickly, in contrast with many other sectors.

There are a number of theories relating to the underwriting cycles that have an empirical support. One theory is based on the expected investment income (or more generally investment returns) that can be earned on insurance premiums. If interest rates (or rates of return) are expected to rise, then some insurers may reduce insurance prices in order to attract more premiums in expectation of these higher returns. Other insurance companies, not wishing to lose market share, may also then reduce their insurance prices. Similarly, if interest rates fall or are expected to fall, insurance rates should then tend to rise, after a time lag.

A second theory is founded on the availability and cost of equity capital, which might be considered more relevant than debt capital because insurance regulators accept equity capital for solvency purposes while restricting the use of debt capital. According to this theory, there are two main effects when stock markets rise markedly. First, the cost of capital falls for both existing and new insurance companies. Second, rising share prices increase the value of insurance companies’ financial asset holdings and bring about an even greater increase in their capital and reserves. The increased availability and reduced cost of capital tends to increase supply and hence exert downward pressure on insurance prices. Similarly, if stock markets fall markedly and remain depressed, insurance prices will tend to rise.

A third, ‘claims shock’, theory holds that claims experience rather than capital markets effects are the key cause of cycles. It supposes that insurers tend to underestimate the potential for claims when there are no large individual losses or accumulations of loss. However, when a very large loss occurs, insurance prices rise sharply, especially if the effect of the loss is to deplete capital or cause insurer insolvencies. Subsequently, and in the absence of further major losses, insurance prices tend to fall as a consequence of competitive forces until another large loss occurs. This theory, based on the concept of an ‘economic shock’, assumes that insurers have a short memory. The theory also supposes that following a major loss, insurers will try to recover some of their losses, especially if claim payments were well beyond those anticipated when premiums were fixed. Of course, exceptionally large losses or accumulations of loss are likely to be more or less random in their timing, but their effects may appear to be cyclical.

Evidence suggests that all the theories and effects described above can operate together but in differing degrees of importance, varying with the type of insurance. For example, it has been suggested that cycles in the price of insurance covering natural catastrophes are more likely to be caused by the ‘claims shock’ phenomenon, while less risky types of insurance are more likely to be influenced by capital market effects. Furthermore, there are indications that the insurance cycles have a big effect on large risks and a smaller effect on SMEs and micro businesses.

5. Insurance markets: basic structure

The object of this section is to provide a brief overview of insurance markets, to identify the main players and describe their function. We begin by describing the various types of enterprises that underwrite insurance, or act as risk carriers. We will then examine various types of intermediaries that bring buyers and sellers of insurance together and so act as distribution channels.

Insurance undertakings in the sense of risk carriers can be classified in various ways, for example:

- according to whether they are proprietary insurance companies or mutual insurers;
- according to the line(s) of insurance they write;
- according to whether they are direct (primary) insurers or reinsurers;
- according to whether they are independent of any particular buyer of insurance or closely affiliated to a particular buyer or group of buyers (as in the case of captive insurers or reinsurers).

In addition there are specialist insurance exchanges (bourses) such as Lloyd's of London.

5.1 Proprietary and mutual insurers

Proprietary companies are owned and financed by shareholders whose liability for losses is restricted to the nominal value of their shares. Shareholders receive their share of profits by way of dividends.

Conversely, mutual insurers are owned by their policyholders.

The significance of mutuals in the provision of business insurance is small in some markets, such as in the UK, and significant in others, as in France. It shall be noted that legislation on mutuals differs between Member States.

Recently there has been a trend towards 'demutualisation' in some countries, meaning that mutuals have been converted into limited liability companies. Sometimes this has been in response to capital weakness – mutuals cannot turn to the capital markets in order to raise capital - and sometimes to give mutuals the opportunity to acquire other companies by issuing shares rather than using cash.

Contrary to mutual insurance companies that will, generally, accept business from the public or industry at large, mutual indemnity associations originally accepted business only from members of the particular business, profession or trade from which the association originated.

'True' mutual indemnity associations are essentially trade bodies. They are, in effect, common pools into which members of a particular profession or trade contribute, and from which they can make a claim when necessary. Historically, they were often formed when members of a particular trade felt that the cost of commercial insurance was too high in the light of their own particular claims experience, or when they had insurance needs which could not be met adequately by the commercial market at the time. Examples of trades that have formed such associations at one time or another include physicians, pharmacists, farmers, furniture manufacturers and ship owners.

Over the years many of these associations have been taken over and absorbed into the conventional insurance market or reformed as mutual or proprietary insurance companies. In some cases they have had to accept business from members of the public in order to create greater financial stability and a wider spread of risk.

5.2 Specialist, multi-line and composite insurers

5.2.1 Specialist insurers

Specialist insurers underwrite one type of insurance business only. At one time, a number of countries, including some in the EU, had ‘monoline laws’, restricting insurers generally to one line of business, or requiring that certain classes (for example, credit or legal expenses insurance) be written by specialist insurers only. Generally, these mono-line laws have now disappeared. Companies that specialise in one or a few lines of insurance now do so for reasons of business strategy.

5.2.2 Multi-line insurers

Multi-line insurers are simply those that write several or many lines of business.

5.2.3 Composite insurers

Composite insurance companies are those that were originally given authorisation to underwrite life and non-life business at the same time. However, current EU legislation does not allow as a general rule the formation of new composites. Member States are able to derogate from this prohibition only for life assurance classes and non-life insurance classes 1 and 2 (accident and sickness)[17], and only for undertakings already authorised as composite insurers on 15 March 1979 (or later for Member States accessing the EU at later dates)[18]. This derogation has also been provided for the New member States; therefore their undertakings existing before 1 May 2004 and having authorisation to underwrite both life and non-life insurance business can continue to do so[19]. However, in this case, the Member States have to impose strict requirements of separate management of the life and non-life business.

5.3 Reinsurers

To reinsure means simply to insure again, so a reinsurance contract is an insurance against losses on an insurance policy, or an insurance upon an insurance. In the EU, reinsurance is regulated in the Reinsurance Directive. It shall be noted that this Directive only applies to companies doing reinsurance business and which are not already authorised in accordance with the life or non-life insurance Directives.

Reinsurers can be divided into the following categories:

- specialist (‘professional’) reinsurance companies;
- ordinary (‘direct’ or ‘primary’) insurance companies that write reinsurance business also;
- Lloyd’s syndicates.

Reinsurance can be arranged facultatively or through a standing reinsurance treaty. In the first case the reinsurance is optional rather than obligatory: the direct insurer offers a risk which is not automatically covered under an existing treaty to one or more reinsurers who may then

17 Art. 18(2) of the Life Assurance Directive 2002/83/EC

18 Art. 18(3) of the Life Assurance Directive 2002/83/EC

19 Council Directive 2004/66/EC of 26 April 2004 adapting Directives 1999/45/EC, 2002/83/EC, 2003/37/EC and 2003/59/EC of the European Parliament and of the Council and Directives 1977/388/EC, 1991/414/EC, 1996/26/EC, 2003/48/EC and 2003/49/EC, in the fields of free movement of goods, freedom to provide services, agriculture, transport policy and taxation, by reason of the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia.

accept or decline it.[20] A treaty reinsurance is a standing insurance contract between a direct insurer and one or more reinsurers under which the former agrees to cede (transfer) and the latter to accept automatically a certain proportion of the risks[21] falling within a class defined by the treaty, or losses beyond a certain level arising from them. Risks falling outside an insurer's existing treaty arrangements (because, perhaps of their size or unusual character) may be offered to reinsurers facultatively, as described above.

There are many forms of reinsurance, but they fall into two basic types. The first is proportional (pro-rata) reinsurance under which the reinsurer(s) agree to accept a defined proportion of all risks of a certain class. Claims are then shared between the direct and reinsurers in the same proportion. Premiums are shared on the same basis, with allowances for commission and brokerage. The proportion of each risk transferred to the reinsurer may be fixed (quota share) or variable according to the size of risk (surplus share).

The second basic form of reinsurance is non-proportional. In this case the reinsurance contract hinges on the sharing of claims that actually occur rather than on any prior division of risk. For example, under one of the most common forms of non-proportional reinsurance, excess of loss reinsurance (XL), the reinsurer(s) agree to bear the balance of any single loss (or accumulation of losses from one defined event) that exceed a threshold (for example, EUR 1 million) defined in the reinsurance contract.

Reinsurance is often arranged in layers. Several reinsurers may participate in each layer of cover, meaning that large losses may ultimately be spread amongst a large number of reinsurers.

Reinsurers may themselves reinsure some of the risks they have assumed, this further transfer of risk being known as retrocession. For example, a reinsurer which provides proportional (pro-rata) reinsurance capacity to insurance companies may wish to protect its own exposure to catastrophes by buying excess of loss protection. Again, a reinsurer which writes excess of loss reinsurance may want to protect itself against an accumulation of losses across different lines of insurance business which may all become affected by the same catastrophe, for example when a windstorm causes damage to property, vehicles, ships and loss of life. The process of retrocession can sometimes continue until the original reinsurance company unknowingly receives some of its own business (and therefore its own liabilities) back. This is known as a 'spiral'. In the 1980s Lloyd's and the London insurance market (which is the largest forum for retrocession business) was badly affected by the development of reinsurance spirals, which concentrated risks into the hands of a few reinsurance syndicates. A series of catastrophic losses in the late 1980s bankrupted some of these syndicates.

Reinsurance can be arranged directly between the ceding company and the reinsurers or arranged through an intermediary, which may be an insurance broker that also arranges direct business or a specialist reinsurance broker.

Reinsurance and reinsurance markets are considered in more detail in Chapter VIII.

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[20] Except in the case of a facultative-obligatory reinsurance, under which the reinsurer is obliged to accept certain defined risks if they are offered.

[21] Not all treaties require the reinsured to cede every risk. Surplus treaties often allow the insurer to decide whether or not to cede risks, although the reinsurers are committed to accept all ceded risks (within set parameters). Only in a "Quota Share" agreement, all risks are always ceded.

5.4 Pools

Coinsurance[22] or co-reinsurance groups (often simply called pools) are risk-sharing partnerships among otherwise independent insurers and reinsurers. Typically, they are formed in order to create a broader underwriting base for exceptionally large, ultra-hazardous or unbalanced risks or groups of risks. Members agree to write the risks in question only within the scope of the pool. Each insurer benefits from the profits of the pool (or suffers its losses) according to its own proportionate interest in the pool. The pool members collectively will often cede or accept reinsurance to produce a further spread of risk.

There are two main forms of pool. In the case of a coinsurance pool, members share the risks within it directly (i.e. as primary insurers). In the case of a reinsurance pools (or co-reinsurance pool), a primary insurer writes the risks and then allocates them among the participating insurers by way of reinsurance.

The commercial argument for insurance pools is that, in some cases, market failure would occur without them, owing to lack of capacity and/or lack of expertise among individual insurers in the market. Pooling allows difficult risks to be diversified effectively and allows pool members to develop expertise in risks with which they are unfamiliar. The most common examples are pools for nuclear risks. There are also, among others, pools for terrorism risks, pollution and environmental liability risks.

5.5 Captive insurance companies

Captive insurance is a method of risk transfer that has become very common in recent years, especially amongst large national and international industrial corporations. Typically, the parent company or group forms a subsidiary company to underwrite certain of its insurance risks. Indeed, the incentive for many large industrial groups to form a captive company is to cover the low quantum/high frequency risks, where the value of the insurance is limited. Another incentive for setting up a captive might be to obtain coverage for risks which are otherwise uninsurable in the market, due to the unwillingness of the commercial insurance market to write particular risks, or to provide full cover[23].

The main objects in establishing a captive are:

- to obtain the full benefit of the parent company/group's risk control techniques by paying premiums based on its own experience;
- to avoid the direct insurers' overheads and administrative costs;
- to retain as much of the premiums, and the investment income on them, as possible within the group;
- to obtain tax advantages and the lower cost of (less rigorous) regulation in an offshore base.
- to obtain a lower overall risk premium level by purchasing reinsurance 'wholesale' and at lower cost than that required by the conventional or direct insurer.

The last point is particularly significant. As explained above, direct insurers usually retain only a portion of many large risks and reinsure the portion that is above their financial ability to retain. As the direct or primary insurer has all the acquisition and survey costs to bear,

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[22] It shall be noted that Directive 78/473/EEC on Co-insurance provides specific rules for co-insurance arrangements that fulfill the conditions stipulated in that Directive.

[23] It may be noted that the Reinsurance Directive 2005/68/EC applies to such captive reinsurance undertakings that fulfill the criteria contained in Article 2(b) of that Directive.

the net cost of reinsurance is substantially lower than the cost of direct insurance. Therefore, captive insurers can have access to the lower cost reinsurance market and, through the proportion of the risk retained, still have the advantages for the group of self-insurance for that amount of risk.

Although only larger groups tend to create captives, the growth in their numbers has been striking in recent years. See the table below.

1920s	first captives formed
1970	163 captives worldwide
1980	1,350 captives
2000	4000 + captives worldwide
2005	5200 + captives worldwide

Many captives are operated from offshore locations, mostly due to reasons of favourable taxation regimes and to avoid the mostly more stringent regulatory framework at the parent company's location. At present, around 3,000 captives are located in the Caribbean, 1,200 in Europe and Asia and around 1,000 in the US.

There are many different types of captive.

Among the EU Member States, there are a number of significant captive domiciles including Dublin (Ireland), the Channel Islands (UK) and Luxembourg. In many cases national legislation has been passed specifically to encourage captive formation.

5.6 The Lloyd's Insurance Market

Lloyd's of London is in itself not an insurer but a market place where insurance is bought and sold. Hence the old saying that insurance is written *at* Lloyd's and not *by* Lloyd's. Originally, the only insurers at Lloyd's were individual Lloyd's Members ('Names') who grouped themselves into syndicates to accept insurance business, traditionally with unlimited personal liability. Risks were accepted on behalf of Lloyd's Members by professional underwriters employed by Underwriting Agencies (underwriting firms). Lloyd's Names were either "Working Names", that is, professionals who worked in the market itself, or 'External Names', who were simply investors in the market. Despite the special structure of Lloyd's, the EU insurance legislation applies to the Lloyd's market, e.g. to "the association of underwriters known as Lloyd's".

Lloyd's share of the world insurance market is relatively small (less than 2% of the world market for non-life insurance). However, its importance for the European insurance market as well as for certain large risks (such as aviation) is considerable. Lloyds is a focal point in the London insurance business, where approximately 10 to 15% of world's reinsurance and large commercial insurance business, including around 15% of all marine business, 27% of world aviation insurance and as much as 60% of all energy business, is written.

Lloyd's suffered from an exceptional number of catastrophes in the late 1980s and early 1990s, some (such as hurricanes and floods) the product of natural perils, and some (such as the *Piper Alpha* oil-rig disaster in 1988) man-made. Liability claims (especially from asbestos and pollution risks in the United States of America) also hit Lloyd's hard. The resulting losses, around EUR 16 billion in five years, resulted in huge cash calls on Lloyd's members, around 1500 out of a total of 34,000 of whom were declared bankrupt. However, Lloyd's underwent a process of reconstruction and renewal. One key result has been the introduction of 'Corporate Names' to provide new capital. Companies may now invest at Lloyd's, often taking the form of investment trusts. The growth of 'corporate capital' at Lloyd's has been very rapid. It now provides most of Lloyd's capacity (about 80%) as the contribution of the 'traditional' Names continues to shrink. Insurance companies – predominantly US, Bermudian and Continental European firms – provide about half of this capacity. They gain thereby the ability to write business in more than 60 countries through Lloyd's overseas licenses. Furthermore, many of the remaining 'old' Names are converting from underwriting on an unlimited basis to underwriting on a limited liability basis.

At present, capital at Lloyd's is provided by:

- 55 corporate members
- 1,497 individual underwriting members ('Names') with unlimited liability[24]
- 468 individual underwriting members with limited liability

Other market participants include 46 managing agents, approximately 60 syndicates and 164 Lloyd's brokers.

There have also been many mergers amongst the syndicates and companies operating in the market, so Lloyd's is becoming more like an ordinary insurance company or, at least, like a group of insurance companies.

Lloyd's is not entirely unique as an insurance market as other insurance exchanges have been established from time to time around the world. For example, there is a somewhat similar Dutch Co-insurance Bourse (VNAB) though this, like other such bourses, does not operate on the scale of Lloyd's.

5.7 Intermediaries and their classification

Insurance can be distributed by insurance companies through the use of direct marketing; for example, through call centres ('telesales') or the Internet, or via the company's own sales force operating from branch networks. In some markets, even large industrial risks have traditionally been placed directly with insurers, which maintain special departments to service their large commercial and industrial clients. However, in many mature insurance markets a large volume of insurance, and often most business insurance, is arranged through intermediaries.

Classifying insurance intermediaries presents some problems, because the terms used to describe them are not used consistently across different insurance markets, or even within some individual insurance markets.

Historically, there has been relatively little regulation of insurance intermediaries in the EU, at least in comparison to the degree of regulation applied to insurance companies. Furthermore, the national laws on insurance intermediaries that did (and still do) exist often adopt different classification systems for insurance intermediaries. Regulation of insurance intermediaries at EU level has now been brought about through a Directive on Insurance Intermediation[25]; however, while the Directive refers in its preamble to 'agents', 'brokers' and 'bancassurance operators' these terms are still not defined and they are not used in the Directive itself, which employs the generic term 'insurance intermediary' throughout.[26] The general approach of the Directive is that the same provisions shall apply to all kinds of intermediaries.

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[24] The Corporation of Lloyds has indicated that it wants to eliminate unlimited liability.

[25] Directive 2002/92/EC. In 1992, the Commission had already adopted Recommendation 92/48/EEC on insurance intermediaries. The Recommendation was largely followed by Member States but, given its non-binding nature, substantial national differences remained.

[26] This term is defined in the Directive, along with variations such as 'reinsurance intermediary' and 'tied insurance intermediary'.

Notwithstanding its inexactness and the lack (in many Member States) of any strict legal significance, the most commonly-adopted basic distinction is that between insurance agents and insurance brokers. However, other categories are sometimes added. For example, banks, which are important operators in many insurance markets, are often regarded as a distinct form of distribution channel.

In order to understand the role, status and responsibility of particular insurance intermediaries, and label them appropriately, the following questions need to be addressed:

1. How independent is the intermediary and what range of products can they offer? Are they contractually bound to sell the products of just one insurer, or able to offer clients the competing products of several insurers, or of many insurers?
2. Is the intermediary an insurance 'professional', with specialist knowledge, or is the selling of insurance an activity which is incidental to some other business or profession in which the intermediary engages?
3. To whom is the intermediary responsible – the insurer or the (would be) insured?

5.7.1 Brokers

The term "insurance broker" is generally reserved for fully independent, specialist insurance intermediaries. They are not tied to any specific insurance company or companies and are able to select insurers to meet their clients' needs from a wide range of providers rather than just a few. An insurance broker's full-time occupation or business is the placing of insurance with insurers. In doing so, he is capable of exercising a relatively high level of skill and knowledge in the insurance field.

Insurance companies often grant a higher level of authority to insurance brokers than to other intermediaries. For example, some brokers may have authority to grant cover for certain classes of insurance and, in some cases, to issue policies and pay claims. Furthermore, brokers (and especially the largest firms) usually have a wider range of competencies than other insurance intermediaries and can offer a variety of services in addition to insurance placement. These may include, for example, risk management, actuarial, loss control and claims management services.

In general terms, an insurance broker should always be acting on behalf of the insured or would-be insured. However, the status of an insurance broker is somewhat unusual. While, as a rule, intermediaries in the commercial sphere act on behalf of one party only, insurance brokers may act for both parties in certain instances – this can present a risk of conflict of interest.

For example, a potential client may instruct an insurance broker to select an insurance company and arrange cover on their behalf. In selecting the insurer and assisting the client with the necessary documentation (for example, by completing a proposal form) the broker clearly does so as agent of the client. As a consequence, any errors or omissions in the documentation will be attributable to the client. On the other hand, if the insurer subsequently sends the broker documents and the insurance has not yet been paid for (in the case of a credit agency) then the broker holds the documents on behalf of the insurer and acts as agent of the insurer. Again, insurers might have given brokers authority to grant cover or settle claims on their behalf and, in doing so, brokers clearly act for the insurer. Inevitably there is thus some scope for conflicts of interest when an intermediary acts for both parties.

5.7.1.1 Economic function of brokers

The long-term economic effect of brokers should be to reduce risk costs and to facilitate a truly competitive market. In economic terms, they fulfil three main roles:

Reducing search costs. Brokers reduce the resources expended or the costs incurred by insurance buyers when seeking for insurers and those incurred by insurers in seeking clients.

Reducing uncertainty. Buyers and sellers have asymmetric information on the product or service being sold, making it difficult for them to agree on the price and terms of the contract to be concluded. Also, in insurance the client knows specifics of the risk that the insurer might not be aware of. On the other hand, the insurer knows more about prevailing market conditions. Brokers provide a channel for information that reduces this asymmetry and, since they rely on long term relationships, they should have an incentive to ensure that neither party acts in an opportunistic way.

Asymmetric bargaining power. Small and medium-sized buyers of insurance may have significantly less bargaining power when dealing with large providers. Brokers are able to secure better terms for such clients, thus reducing asymmetries in bargaining strength.

5.7.1.2 Brokers' business models

Brokers operate under a variety of business models, but there is a broad division between 'global' brokers, regional or niche operators, and wholesale brokers.[27] Some brokers may combine the characteristics of more than one model.

Global brokers are by definition large firms with international operations, tending to seek large and medium sized corporations as their main clients. Their structure varies, but a typical broker of this type might comprise a 'retail' unit, which liaises with clients, analyses their needs and designs and structures appropriate insurance programmes, a 'placement' unit, which places the programme with insurers, and a 'service' unit which provides ongoing advice and assistance to the client for the duration of the insurance programme.

Regional or 'niche' brokers also design and structure risk and insurance programmes for their clients, but often work with a wholesale broker (see below) to place risks in the international insurance market. Some of these firms may specialise in a particular commercial or industrial sector (e.g. the construction industry), particular form of insurance (e.g. credit insurance) or particular form of risk transfer (e.g. catastrophe bonds and other alternative risk transfer (ART) products). These are generally small or medium sized firms which may be unable in themselves to provide the wide range of services offered by the largest brokers and, as consequence, may work with independent specialist firms (e.g. risk management companies or actuarial consultants) in order to compete with the large international brokers. Regional brokers break down into medium sized full service chain brokers, broker networks and local/high street brokers.

Wholesale brokers, as the name suggests, may have no 'retail' operations at all and may specialise in the placement of risks in international markets that have been referred to them by a regional broker. However, some wholesale brokers may have retail units in at least some parts of the world and rely on regional brokers for business in those territories where they themselves are not represented. Also, global brokers place a large amount of wholesale business through their networks.

There may well be two or more brokers in the insurance distribution chain. In some cases the first broker in the chain may be known as the 'producing' broker as distinct from the 'placing' broker. However, the terminology used in insurance broking is not wholly consistent.

5.7.2 Agents

From a legal point of view, an agent is simply one who acts for another. However, in insurance, the term is usually reserved for the individuals or firms, other than brokers, who act

[27] See Swiss Re, *sigma* No. 2/2004, p. 11 and Cummins, J.D. and Doherty, N.A. (2005) '*The economics of insurance intermediaries*', Wharton School, University of Pennsylvania for fuller and more detailed discussions of the role of insurance brokers and the economics of their operation.

as insurance intermediaries. Insurance agents vary greatly in terms of their characteristics, authority and operation.

Applying each of the three questions raised above, we can note first that insurance agents are typically less independent than insurance brokers. In the extreme case the agent may be an ‘exclusive agent’, contractually bound to offer the products of one insurer only, or only non-competing products of more than one insurer. On the other hand, the agent may be a ‘multiple agent’ able to offer clients competing products from a wide range of insurers. In this case the agent may have a degree of independence not dissimilar to that of a typical insurance broker.

When considering question 2, there is also a range of possibilities. Some insurance agents are not ‘professional’ insurance intermediaries: sometimes, their main occupation is in another field. For example, insurers may appoint real estate agents, law firms, accountants, car dealers, garage proprietors, banks and financial services firms as their agents: their clients may require insurance cover on various occasions; firms such as these are in a good position to arrange it. Conversely, for many insurance agents, giving advice on and arranging insurance is a full-time occupation or business. Thus a multiple agent of this type is not unlike an insurance broker.

As regards question 3, insurance agents, unlike insurance brokers, are generally regarded as agents of the insurance companies they represent rather than agents of their clients. However, there is no reason why an insurance agent should not, in principle, act on behalf of the client on some occasions. For example, if a client of a multiple agent seeks general advice on their insurance needs, and the advice is negligent, then the agent would carry legal responsibility for such negligence, and one could not attribute the actions of the agent to any particular insurance company.

The authority granted to insurance agents varies widely. In some cases it may be very limited, perhaps only to the introduction of business, with no authority to collect premiums, grant cover or pay claims. In other cases, in particular with certain specific multiple agents, the authority may be extensive and similar to that of a typical insurance broker.

Finally, we can note that insurance intermediaries, whether brokers or agents, vary greatly in terms of their size and legal status, ranging from private individuals to international corporations with thousands of employees world-wide.

5.7.3 Banks and Insurance

The involvement of banks in insurance occurs at various levels. Close affiliations between banks and insurance companies (and, in some cases, securities houses and other financial firms), and the involvement of any one in the business of the other(s), is commonly encapsulated in the umbrella term ‘bancassurance’.

Historically, legislators in many countries have often forbidden or severely restricted close affiliations between banks, insurance companies and other financial firms. This was emphatically the case in the United States of America, where depression-era legislation that severely constrained such affiliations has been dismantled only within the last few years. European laws on this matter have traditionally been rather more liberal. In any event, there has been a process of further liberalisation in recent years, not only in Europe but worldwide, leading to the formation, in many markets, of financial conglomerates including bank and insurance companies in the same group.

Liberalisation within the EU has been driven largely by the desire to increase European integration, strengthen competition and allow firms to reduce risk through diversification. Nevertheless, EU laws generally do not permit banks to underwrite directly insurance business, just as insurers are forbidden from engaging in banking business directly (or indeed, in engaging in any business other than insurance). This means that a bank's involvement as a 'manufacturer' of insurance products, as distinct from a distributor, must be indirect.

From the point of view of banks and insurers themselves, close affiliations may offer the potential for generating economies of scale and scope. Specific potential benefits may include the gaining of access by one or both of the affiliates to the customer base of the other, opportunities for cross-selling, lower marginal costs in generating new business, benefits derived from the superior brand or image of the affiliate and downstream vertical integration to secure distribution.

Banks are involved in insurance business as distributors of insurance. Such involvement can take two main forms:

- bank as agent;
- bank as broker.

In the first case the bank in question simply acts as an agent of one or more insurance companies, distributing insurance products underwritten by the latter. In the second case the bank in question establishes or acquires its own insurance broking subsidiary. In this case, the bank's broking subsidiary will place business with a range of different insurers, just like any other broker.

In Chapter IV the insurance activities of banks are discussed briefly in the specific context of the EU.

5.7.4 Classification of intermediaries for the purpose of the sector enquiry survey

There is clearly some overlap between the different types of insurance intermediaries and there are different ways of classifying them. In the questionnaires used to gather information for the Sector Inquiry, the following classification and definitions were adopted:

1. Exclusive agent – an intermediary who acts 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 3 below).

2. Other agent – an intermediary who is acting as an agent of the insurer and who has multiple insurer agency agreements (except 3 below).

3. Bank – a bank or lending institution acting as an insurance agent or insurance broker.

4. Insurance broker – an intermediary acting as an agent of the insured, who is not tied by agreement to refer business to an insurer (except 3 above).

5.8 Other participants in the insurance market

Besides the main players described above, the insurance market is served by a number of specialists. These include independent loss adjusting firms, which are appointed by insurers to handle larger and more complex claims. In addition to loss adjusters there are also loss assessors who act on for policyholders and negotiate claims on their behalf with a view to obtaining the most favourable settlement for them.

A wide variety of firms provide additional services to the insurance industry. They include actuarial consultants, risk modelling specialists, accountancy firms that specialise in various types of insurance work and, in many markets, specialist insurance law firms.

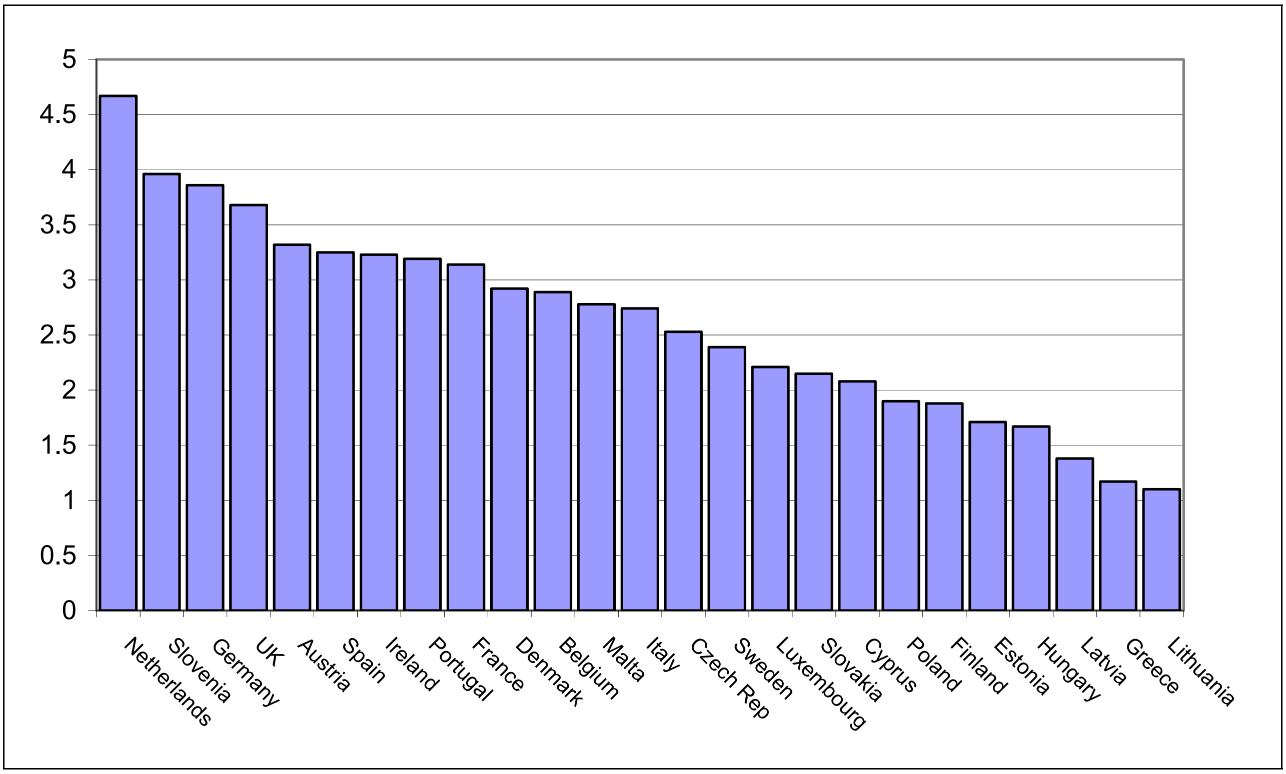
IV. CHARACTERISTICS OF THE WHOLE EU INSURANCE MARKET

1. OVERVIEW OF THE EUROPEAN NON-LIFE INSURANCE MARKET [1]

The European non-life insurance market, collectively, is comparable, but nevertheless smaller, in size to that of the US, the other major world market. Germany has the second biggest national market after the US, and that of the UK ranks third, just ahead of Japan. Among the top ten national non-life insurance markets, six are EU Member States. In fact, EU Member States account for the greatest part by far - around 90% - of European non-life premiums, even if Europe is defined very broadly. The only substantial European non-life markets outside the EU 25 are Switzerland[28] (accounting for about 3.5% of all European non-life premiums), Russia (about 3.2%) and Norway (about 1.3%).

The size of national non-life markets in the EU varies enormously. The six biggest EU non-life markets command over 83% of premium income while the six smallest account for barely 0.5%.

Figure IV.1 - Non-life insurance penetration in the EU: premiums as % of GDP 2005



Source: Swiss Re, sigma No. 5/2006, p.37

Premium volumes for the major world non-life markets are detailed in the table that follows (EU Member States highlighted).

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28 Among the non-EU insurance markets of Europe Switzerland is, for the present time at least, the most significant by far, since it is home to some of the major pan-European non-life insurance groups, including Zurich and Winterthur. Swiss reinsurers also command around 14% of world reinsurance premiums.

Table IV.1 - Non-life insurance volumes in EUR mio

Ranking 2005: World & (EU)	Country	Premiums 2005	Premiums 2004	% change (inflation adjusted) 2004 & 2005	Non-life share of all business	World share 2005 %	EU share 2005 %
1	USA	503505	487958	2.0/-0.3	54.8	43.10	
2 (1)	Germany	86106	85305	1.5/-1.0	54.3	7.37	22.99
3 (2)	UK	80959	79589	-1.0/0.2	33.5	6.93	21.62
4	Japan	80874	84881	-0.5/-4.2	21.1	7.92	
5 (3)	France	54838	53385	2.1/0.9	30.7	4.69	14.64
6 (4)	Italy	38177	37237	2.5/0.7	34.1	3.27	10.20
7	Canada	35614	32897	2.3/-0.5	56.2	3.05	
8 (5)	Spain	27963	26054	5.5/3.8	57.8	2.39	7.47
9 (6)	Netherlands	23460	23198	na/-.06	47.7	2.01	6.27
10	Australia	19550	18545	0.6/-1.0	46.8	1.67	
11	S. Korea	19377	16336	2.4/6.7	29.0	1.66	
12	PR China	16524	14247	17.0/12.7	34.2	1.41	
13	Switzerland	14747	14421	3.2/1.5	44.6	1.26	
14	Russia	13370	10306	17.6/12.0	94.8	1.14	
15 (7)	Belgium	12363	11919	na/0.9	33.1	1.06	3.30
16	Brazil	10780	7913	6.9/6.0	55.9	0.92	
17	Taiwan	8204	7566	3.7/2.1	20.8	0.70	
18 (8)	Austria	8097	7799	3.0/1.3	53.3	0.69	2.16
19 (9)	Ireland	7885	7307	na/na	32.9	0.67	2.11
20 (10)	Sweden	7115	6828	11.3/5.4	31.9	0.61	1.83
21	Mexico	6053	5681	4.1/-1.1	58.9	0.52	
22 (11)	Denmark	6023	5970	na/-0.9	35.8	0.52	1.61
23	S. Africa	5838	4987	12.3/11.8	21.9	0.50	
24	Norway	5409	4852	4.0/4.9	41.7	0.46	
25 (12)	Poland	4439	3708	6.0/3.8	58.4	0.38	1.19
26 (13)	Portugal	4219	4253	0.3/-3.1	31.4	0.36	1.13
27	India	3900	3707	10.1/11.5	29.4	0.33	
28	N. Zealand	3852	3688	0.0/0.5	84.4	0.33	
29	Turkey	3851	2618	23.3/10.7	83.8	0.33	
30	Israel	3216	3831	1.0/0.7	53.8	0.28	
31 (14)	Finland	2862	2833	5.7/0.2	20.1	0.25	0.77
35 (15)	Czech Rep	2412	2138	3.1/3.2	61.6	0.21	0.65
37 (16)	Greece	2031	1895	na/na	52.3	0.17	0.54
44 (17)	Hungary	1505	1374	-1.4/4.1	55.6	0.13	0.40
47 (18)	Luxembourg	1171	1094	na/na	10.8	0.10	0.32
49 (19)	Slovenia	1085	1027	4.6/3.1	70.1	0.09	0.29
52 (20)	Slovakia	860	765	7.1/5.2	62.9	0.07	0.23
69 (21)	Cyprus	287	267	na/na	50.9	0.02	0.08
78 (22)	Lithuania	219	204	12.0/7.9	72.3	0.02	0.07
81 (23)	Latvia	185 (est)	175	na/na	na	0.02	0.05
83 (24)	Estonia	172	151	11.7/9.5	68.1	0.01	0.05
85 (25)	Malta	122	116	na/na	46.5	0.01	0.03
	EU 25	**374555**	**364591**	**-**	**-**	**32.06**	**100**
	World	**1168186**	**1123468**	**2.3/0.6**	**42.4**	**100**	

Source: Swiss Re, sigma Nos. 2/2005, p. 39 and 5/2006, p. 35

The number of non-life insurers in Europe has declined steadily in recent years. However, there are still close to 3,000 non-life companies operating within the EU insurance market, with an average premium volume of around EUR 125 million each. This compares with around 2,500 providers in the larger US market, where premium volumes average around EUR 200 million. By contrast, the large Japanese non-life market is highly concentrated, hosting fewer than 60 insurers – no more than in Austria – with an average premium volume in the region of 1,350 million.[29]

The concentration of non-life insurance providers within individual EU Member States varies significantly. Measured in terms of the market share of the ten biggest companies, it ranges from around 50% in Germany to over 95% in Finland, Sweden, Ireland and several new Member States. It seems that this is at least in part attributable to the size of the market: the bigger the market the smaller the shares of the biggest insurers. In most Member States non-life market concentration has increased in recent years.

2. THE INTEGRATION OF EU INSURANCE MARKETS

Historically, the European insurance market has been largely fragmented, consisting of a number of national insurance markets which, to a large extent, developed independently of each other. This fragmentation has been the result of a mix of influences, including the nature of national insurance regulation, local distribution systems and the ownership characteristics within the insurance sector in some markets, such as those dominated by mutual insurers or state-owned enterprises. One of the objectives of the wider programme to create a single financial services market in Europe is precisely to address this fragmentation (see chapter V for a more detailed description of the extent of integration of EU insurance markets).

2.1 The impact of insurance regulation in Europe

The aims of insurance regulation at EU level is to create a framework for an integrated insurance market in which insurance contracts can be arranged between risk carriers and policyholders in different EU Member States with comparative freedom from restrictions or differences in the regulatory environment at national level, while ensuring that consumers still enjoy an adequate level of protection. Integration is expected to benefit both buyers and sellers of insurance, giving the former a wider choice of suppliers and products and a higher degree of competition and giving the latter the potential benefits of increased regional risk diversification and possible economies of scale.

EU legislators have attempted to remove, or at least lower regulatory barriers between Member States by introducing coordinated rules on insurers, with e.g. rules on the initial authorisation, ongoing supervision and solvency requirements, coordinated rules on intermediaries and an opening of the market to competition in terms of policy terms and premiums charged.

The European insurance Directives[30] have thus provided to the insurance companies operating within the European Union the freedom of establishment and the freedom to provide services on the basis of a Single Passport and Home Country Control. Other obstacles, affecting particular lines of insurance or insurance activities have been addressed through a further series of directives.[31]

Despite this, not all the barriers posed by different regulatory systems have been removed entirely. This is because the insurance directives do not fully harmonise insurance

[29] Swiss Re, *sigma* No 3/2000, p. 2. According to the authors there were 2,890 non-life insurers operating in Europe in 1998 compared with 2,456 in the US and 57 in Japan.

[30] In the field of non-life insurance: Directives 73/239/EEC, 88/357/EEC, 92/49/EC, 2002/13/EC. For life insurance, the corresponding Directives have been consolidated into Directive 2002/83/EC.

[31] For example, directives on Coinsurance (1978), Third party motor liability insurance (1972, 1984, 1990, 2000, 2005), Tourist Assistance (1984), Credit and Suretyship (1987) Legal Expenses (1987), Insurance Company Accounts (1991), Compulsory Winding-up of Insurance Companies (2001), Insurance Mediation (2002) and Reinsurance (2005).

regulation in the Member States. The directives therefore do not automatically produce an entirely ‘level playing field’.

2.2 Some effects of deregulation

While the efforts to create a Single Market in insurance have led to an increase in the stringency of regulation in Member States where regulation has traditionally been light, (such as the UK, Ireland and the Netherlands), there has been deregulation for many Member States, and on balance for the EU as a whole, most significantly regarding the ex ante controls on insurance prices and policy terms.

Prior to deregulation (and especially the ‘third generation’ of insurance directives) potential competition in Europe was restrained by protracted procedures for obtaining an insurance licence and by regulated ‘tariff’ systems that hindered true price competition in many markets. The establishment of strong distribution systems in those markets dominated by tied agents meant that entry costs for new insurers would tend to be high, giving established insurers a protected market environment. The introduction of the ‘single licence’, coupled with home country control, now allows (at least in theory) much faster market entry. The abolition of national controls over insurance prices and products means that new contracts can be introduced without prior approval from a regulator, allowing efficiency gains and lower prices for consumers.

However, deregulation has not, as yet, led to any significant general expansion in cross-border trade in insurance. Combined with a number of other factors that will be discussed below, deregulation has rather led to an unprecedented wave of mergers and acquisitions (M&As), with European insurers seeking to exploit new market opportunities through the medium of an acquired local insurer rather than by selling directly into the territory concerned. From 1990 to 2002 there were 2,595 M&As involving European insurers as an acquirer and/or as a target. Activity peaked in the year 2000, and 1,669 of the deals resulted in a change of control. These transactions occurred both cross-border and within-border and well as cross-industry (e.g. ‘bancassurance’ deals).[32]

As a consequence, the EU insurance market has become more concentrated. In 1980 there were approximately 7,000 insurers, both life and non-life, in the countries that now make up the EU, and this number has now reduced to fewer than 5,000,[33] amongst which there may be fewer than 2,000 economically independent entities writing non-life insurance.

2.3 The Euro and European capital markets

The introduction of the Euro, and the formation of a massive Euro capital market from a number of nationally fragmented capital markets, has contributed to structural change also in the European insurance industry. Insurance companies, which are amongst the biggest institutional investors, now each own a smaller share of the larger overall market which means that investments can be liquidated more easily while, at the same time, the range of investment products has increased. The Monetary Union thus forces companies to have a wider

[32] M&A activity has been especially intense in relation to UK targets. During this period transactions in which the target was a UK company ran at approximately four times the level, both in terms or number and value, of transactions involving targets in any other large insurance market and they exceeded the total for such deals involving targets in France, Germany and Italy combined. See Cummins, D.J. & Weiss, M.S. ‘Consolidation in the European insurance industry: do mergers and acquisitions create value for shareholders?’ Brookings-Wharton Papers on Financial Services (2004) pp. 217-257.

[33] The CEA (European Insurance in Figures, June 2006) record 4.933 insurers ‘operating’ in the EU-25 during 2004 with the largest numbers in the UK (1167), Germany (677) and France (475). However, a very large number of these are effectively inactive.

geographical spread in their investment portfolios and to gear their portfolio performance to a European benchmark. The shares of insurance companies themselves will increasingly be measured against a European benchmark and companies that do not match up to their rivals will be identified more easily and will find it increasingly difficult and expensive to attract capital funds.[34]

3. CURRENT ISSUES AND TRENDS IN EUROPEAN INSURANCE MARKETS

In this section we consider some key issues and trends affecting European insurance markets. We examine, in turn, trends affecting insurance carriers and insurance brokers and other distribution channels. [35]

3.1 Insurance carriers

We begin by looking at issues and trends affecting direct insurance providers in Europe. In particular, we discuss three trends which are interlinked: a surge in merger and acquisition activity among insurers in the EU, the increasing prominence of European multinational insurers, and increasing concentration within the EU non-life insurance market.

3.1.1 Merger and Acquisition Activity

As stated earlier, deregulation of EU insurance markets prompted a sharp rise in M&A activity in the 1990s leading in turn to more concentrated European markets. While the 1980s saw a large volume of national mergers and acquisitions, cross-border deals became more prominent in the 1990s, rising to 50% of the total in 1999.

Cross-sector M&A transactions have been uncommon in relation to non-life insurance business. Whereas banks and life insurers have exploited opportunities for cross-selling products through common distribution channels, banks seemed to have demonstrated less interest in selling non-life insurance products apart from the few that have acquired property/casualty insurers in order to offer personal lines of general insurance (e.g. motor and home insurance) though their own distribution channels.

By 2003 foreign penetration of national markets was much higher than it had been ten years earlier, except for countries such as Ireland, Belgium and Austria, where foreign ownership had historically been high. In these countries foreign owned companies often changed hands as a result of mergers and agreed acquisitions between insurance companies in other countries, usually in the larger European countries and, in particular, France, Germany, UK, Switzerland and the Netherlands.

3.1.2 Drivers of M&A activity in European insurance markets

M&A activity amongst insurers in Europe seems to have been driven by a number of factors. First, managers may hope to increase the efficiency of their business through economies of scale and scope.

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[34] Swiss Re, (*sigma* No. 3/2000, p. 15) also suggests that from an underwriting point of view the Euro means an even more strongly international flavour in commercial insurance business. They note: '…the abolition of the capital market boundaries removes the last major hurdle to a single European insurance market. The mainly broker-based distribution system makes it easier for companies to conduct business across national borders and encourages the harmonisation of the provider and product structure. Insurers offering commercial insurance across Europe can also diversify their big risks more effectively in an international context, allowing a reduction in the capital base and a subsequently lower cost of capital.'

[35] For a more detailed discussion of the main drivers of change within European insurance markets over the last two decades, see Dickinson, G. (1996) 'The European Insurance Market' in *The Changing Map of Europe*, eds. Silberston, A and Raymond, C. P., Macmillan Press, pp.137-154.

There are relatively few empirical studies of the economies of scale and scope in the insurance industry, but existing literature suggests that efficiency gains are likely to be modest and only to the benefit of very large insurers[36]. However, these empirical studies fail to measure adequately the scale and scope advantages that large international insurers can achieve through global networks of offices: only the large international insurers can effectively service the needs of multinational corporations.

The motives for M&A deals are just as likely to be strategic as economic. For example, in a saturated market a take-over or merger may be the only realistic way to acquire market share and the only way to break into a market where the structure of existing distribution channels makes it difficult to build them from scratch.

It is worth noting that Lloyd's of London mirrors the rest of the European insurance market in its trend of consolidation and enhanced M&A activity. In 1983 there were approximately 400 Syndicates at Lloyd's whereas now the number of those actively trading has fallen to around 60, with a corresponding increase in the average syndicate capacity. However, change at Lloyd's has been driven by additional factors. In particular, it was the Reconstruction and Renewal Initiative of 1992, triggered by the massive Lloyd's losses of the late 1980s, that led to the initial sharp drop in the number of Lloyd's vehicles, as closure and run-off took their toll. Since then, however, M&A activity at Lloyd's has been driven by much the same considerations as in the insurance company market.

3.1.3 The opposite trend: Outsourcers, "virtual insurers"

Along with the tendency for insurance companies to get bigger and bigger, there is also a counter-trend, towards the outsourcing of many insurance functions to specialist firms, information technology being a major, but not the only example. Cost reduction seems to be the main reason for all such outsourcing deals, although critics argue that shifting of responsibility from industry to supplier can damage a company's ability to react and make strategic moves.

When taken to its limit, outsourcing results in the creation of 'virtual' insurers. These are stripped-down insurance operations with the minimum of staff. They focus on a few core competencies – such as product development, pricing, risk selection, marketing and investment – and outsource everything else, including all processing, documentation, customer service, regulatory and management reporting and payroll functions. Most do not have their own buildings and hold only short-term leases; the Internet is the preferred method of distribution.

3.1.4 The rise of European multinational insurers

Swiss Re[37] notes that one of the most significant development in the non-life EU insurance market in recent years has been the rise in prominence of a group of European multinational insurers, which they designate the 'Europeans'.[38] Swiss Re contrasts these with mainly independent domestic providers of insurance ('Nationals' – ranging from large providers with diverse portfolios to very small niche insurers) and companies that are owned mainly by foreign insurers ('Foreigners'). The authors note that in the period 1990-1998 the combined share of European multinational insurers in the six biggest national markets[39] more than

36 For example, one relatively recent study concluded that only multinational insurers with premium volumes of around EUR 2.0 billion demonstrate economies of scale and that it is mainly national insurers which benefit from M&A deals. See Katrishen, F.A. and Scordis, N.A. (1998), Economies of scale in services; a study of multinational insurers, *Journal of International Business,* No. 29 pp. 305-24.

37 Swiss Re, *sigma* No. 3/2000, pp. 17-21.

38 The companies in the study were Allianz (Germany), AXA (France), CGU (now Aviva) UK., Generali (Italy), RSA (UK), Winterthur (Switzerland) and Zurich (Switzerland).

39 Germany, UK, France, Italy, Netherlands and Spain.

doubled, rising from 18% to 39%, and their share of entire EU non-life market also almost doubled, from 16% to 31% in the same period. This expansion was attributable almost entirely to external growth through mergers and acquisitions, as discussed above. These firms built up market share at the expense of both purely national and foreign-owned insurers, even though the former managed to offset a small part of their losses through organic growth.

European multinational insurers are now leaders in most EU national markets and, although their original home markets are still important, the significance of such markets is gradually decreasing relative to other European markets, which often provide better growth possibilities.

It should be noted that the business activity of the European multinational insurers is not limited solely to the EU and the rest of Europe. A number of them (including Allianz, AXA, Zurich, RSA and Aviva) have established a substantial presence in the US and/or the emerging markets of Asia.

Details of the major European non-life groups, based on 2004 premium data are given below.

Table IV.2 - Major European non-life groups, net non-life premiums, 2004

Group	EUR mio *
Allianz (Germany)	37,407
Zurich (Switzerland)	23,140
Axa (France)	20,271
Generali (Italy)	17,261
Aviva (UK)	13,911
Groupama (France)	8,281
Royal & SunAlliance (UK)	8,197
Winterthur (Switzerland)	6,895
ING (Netherlands)	5,813
Eureko (Netherlands)	4,554
Fortis (France)	4,361
Ergo (Germany)	3,491

* includes non-European as well as European business

Source CEA (2006) 'European Insurance in Figures' based on data from Argus de l'assurance (Dec. 2005)

3.1.5 Increasing concentration of EU non-life markets

Given the recent high levels of M&A activity amongst insurance firms in Europe, it is clear that the European insurance market has, in the simplest sense, become more concentrated. Concentration has increased markedly in virtually all the large EU markets and also in most of the small ones. However, concentration has decreased in some markets, most notably in a number of the New Member States.[40] Although the data are not available for all EU-25 Member States, this pattern is clearly revealed in the table below.

[40] In some New Member States for which data in the table is incomplete a reduction in concentration will have resulted inevitably from the breaking of the monopoly of a single state-owned insurer.

Table IV.3 - Market share of the largest non-life insurance groups

(CR5 = first 5, CR10 = first 10)

Country	CR5 1993	CR5 2004	Change	CR10 1993	CR10 2004	Change
Austria	54.6%	63.8%	9.2%	75.4%	81.4%	6.0%
Belgium	51.8%	60.1%	8.3%	68.6%	79.7%	11.1%
Cyprus	34.6%	48.5%	13.9%	53.6%	71.0%	17.4%
Czech Rep.		84.4%			95.0%	
Germany	23.6%	37.0%	6.4%	36.4%	51.0%	13.6%
Denmark	58.2%	69.9%	11.7%	76.1%	84.2%	8.1%
Finland	87.5%	91.3%	3.8%	96.5%	98.7%	2.2%
France	40.8%	52.4%	11.6%	59.5%	71.5%	12.0%
Greece	38.8%	38.9%	0.1%	51.2%	56.1%	4.9%
Hungary	93.8%	81.5%	-12.2%	100%	95.0%	-5.0%
Ireland	50.1%	67.0%	16.9%	79.7%	96.8%	17.1%
Italy	34.1%	69.3%	35.3%	51.8%	87.6%	35.9%
Lithuania		69.7%			89.8%	
Latvia		71.9%			97.6%	
Malta		72.1%			89.2%	
Netherlands		44.0%			64.9%	
Poland		83.9%			92.6%	
Portugal	55.1%	70.1%		75.5%	86.2%	10.7%
Spain	19.5%	38.7%	19.2%	30.8%	56.3%	25.4%
Sweden	84.3%	90.8%	6.5%	94.0%	97.6%	3.6%
Slovenia		93.0%			99.3%	
Slovakia	99.8%	89.7%	-10.1%	100%	97.2%	-2.8%
United Kingdom	29.7%	53.2%	23.5%	44.4%	69.3%	24.9%

Source: CEA (2006) 'European Insurance in Figures',
Axco non-life reports and national insurance associations

This pattern of steadily increasing concentration in Europe mirrors that of the USA where, according to the Insurance Services Office (ISO), concentration in the US property/casualty insurance sector has increased from 229 on the Herfindahl scale in 1980 to 341 in 2004 [41].It is also worth noting that in 2004 the top four US property-casualty insurers had nearly 30% of the US market,[42] whereas the top four European insurance groups have only around 25% of the European non-life insurance market between them. On the other hand, there is no individual EU national market in which the four largest non-life insurers have less than 30% of the whole market.

3.2. Brokers and other distribution channels

In the EU as a whole there is great diversity of distribution channels for business insurance, across national insurance markets, lines of insurance and consumer segments. In this section we briefly examine some of the main trends in insurance distribution and discuss some of the key current issues.

[41] However, concentration in the US remains relatively low, at least according to the standards of the US Department of Justice, which classifies any score under 1,000 as unconcentrated and only a score over 1,800 as indicative of a highly concentrated industry.

[42] Insurance Information Institute, New York (www.iii.org)

3.2.1 The broking sector in general

Insurance brokers can bring together buyers and sellers in different Member States. They have a high involvement in constructing the complex international insurance programmes that are required by large pan-European or multinational firms.

An indication of the relative importance of insurance brokers in selected markets and countries, including the larger EU Member States, is given below.

Table IV.4 - Brokers' share of non-life distribution by country

Country	Total share	Commercial lines	Personal lines
Netherlands	70%	na	na
Ireland	68%	95%	40%
Belgium	65%	na	na
UK (domestic)	56%	85%	32%
UK (London market)	≥ 95%	≥ 95%	not significant
Austria	27%	na	na
Sweden	20-25%	na	na
Spain	22%	na	na
France	18%	na	na
Portugal	16%	na	na
Luxembourg	15%	na	na
Germany	10%	na	na
Poland	10%	na	na
Denmark	10%	na	na
Finland	9%	na	na
Italy	7%	na	na

Source: "Commercial insurance and reinsurance brokerage – love thy middleman"
Swiss Re Economic Research and Consulting, 2/2004

3.2.1.1 Consolidation in the broking sector

A list of the world's largest brokers is given below.

Table IV.5 - Top ten global brokers by revenue 2005

Rank	Company	Brokerage revenues EUR mn.	Country
1	Marsh & McLennan Cos. Inc.	8037,9	United States
2	Aon Corp.	5242,3	United States
3	Willis Group Holdings Ltd	1763,5	United Kingdom
4	Arthur J. Gallagher & Co.	1085,6	United States
5	Wells Fargo & Co.	771,2	United States
6	Jardine Lloyd Thompson Group plc	708,8	United Kingdom
7	Brown & Brown Inc.	623,3	United States
8	BB&T Insurance Services Inc.	608,8	United States
9	Alexander Forbes Ltd.	548,5	South Africa
10	Hilb Rogal & Hobbs Co.	528,9	United States

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There was an extraordinary wave of M&A activity among the leading firms in the period between 1996 and 1999.[43] However, the pace of M&A activity in the insurance broking sector has quickened in recent years.

[43] This period saw Marsh acquire Johnson & Higgins (1997) and the Sedgwick Group (1998), Aon acquire Bain Hogg, Alexander and Alexander (1996), Minet and Jauch & Hubener (1997) and mergers between Jardine

This enhanced trend has been shaped by the same general considerations of efficiency and strategy that are common to all insurance market sectors. Furthermore, insurance brokers have in recent years faced pressure from several directions. Large commercial clients (and they are increasingly large, since many are themselves the product of M&A activity) may now use their size to justify buying less insurance rather than more. They retain more exposures, take bigger deductibles, and increasingly use captives and other corporate vehicles in preference to full commercial insurance. In many cases, they are committed to a philosophy of sophisticated financial risk management, and look for risk transfer techniques that combine traditional insurance risks and traditionally uninsurable risks, in some case preferring that the two be blended in a single product which can be supplied at a lower overall cost.[44]

A business strategy of the major insurance brokers has been to adapt, diversify and equip themselves with new skills. They now offer clients a whole portfolio of risk-related services, which might include environmental, product and workplace safety audits, captive management, legal services, advice on corporate governance, employee benefits consulting and the assembly of sophisticated ART structures. Strength in these disciplines can be acquired quickly only by combining with firms that already possess the necessary skills. This has been a further factor driving merger activity in the broking sector.[45]

For brokers which do not have the means to extend their range of capabilities the logical alternative is to move in the opposite direction: that is, to specialise rather than enlarge and diversify. Some brokers have thus sought to exploit niche markets that are too specialised for the major players to consider or to cultivate clients whose insurance and risk management needs have so far been considered too small to interest the global broking firms.

These two strategies, consolidation/diversification and specialisation, might explain the increasingly polarised nature of the insurance broking sector.

3.2.1.2 Effects of increasing insurance broker importance

Brokers have increased their role in relation to large commercial insurances in most Member States. This is partly because corporate buyers of insurance have sought the services of the brokers to find the best combination of price and contractual terms and conditions, not just in national markets, but in international markets also.

Of course, the role of the broker can be used to strengthen the bargaining position of the commercial customers for whom they act. As such, it can act as a countervailing force to the increased bargaining power of large insurers and reinsurers, discussed earlier. However, brokers might also use this bargaining power, to some degree, to negotiate higher commissions for themselves. Indeed, because broker commissions are sometimes based on premium levels, the full benefit of their bargaining power may not be passed on fully to their corporate clients.

One key capability of the international insurance brokers is their theoretic ability to switch insurance business from national insurance markets to other markets within the EU or elsewhere. This is especially so for some very large risks. This switching capability might have

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Insurance Brokers and Lloyd Thompson (1997), Heath, Lowndes Lambert and Fenchurch (1997) and Benfield and Greig Fester.

44 The transaction cost of capital market solutions (such as securitisation of risk) is likely to fall as liquidity rises, making products such as these even more attractive than traditional insurance in the eyes of large corporate clients. See Doman, A, T. Duchen and M. Markus, 'Brokers *versus* Insurers', *The McKinsey Quarterly*, 1999 No. 3 pp. 26-35.

45 It is interesting to note that, as part of this process of diversification, most large broking firms have quietly dropped the term 'insurance' from their title in favour of something broader and more generic, such as 'risk services' 'risk solutions' or the like.

the effect of increasing price competition in a national insurance market. However, the extent to which insurance brokers will wish to switch business abroad will depend on the current and expected profitability of the insurance business.

3.2.1.3 Broker role *versus* insurer role

The extra size and wider competency of the biggest broking firms might enable them to push insurance rates down whilst, at the same time, allowing them to collaborate with their clients in finding alternative solutions to traditional insurance. Potential insurer responses include the attempted by-passing of brokers through increased direct marketing, particularly in the small and medium-sized business sector, and direct competition with brokers in the provision of fee-based risk-management services.[46]

3.2.2 The involvement of banks in European insurance markets

Evidence suggests that in Europe, nearly all major banks have at least some involvement in insurance business. [47] However, it is apparent that European banks' involvement in life insurance is far greater than their involvement in non-life insurance, especially as regards insurance underwriting (as opposed to insurance distribution). Thus, while many – and probably the majority – of major European banks have set up or acquired life insurance subsidiaries, far fewer have established non-life insurance subsidiaries. No doubt this is because there are much closer synergies between banking and life insurance operations and products than between banking and non-life insurance. Non-life insurance *underwriting* companies owned by banks focus almost exclusively on simple non-life insurance products, such as home insurance, accident and health insurance. Their involvement in marine, aviation and large commercial property/casualty risks is negligible.[48]

There are similar patterns as regards insurance *distribution* by banks. European banks are major distributors of life insurance products, and in a number of EU Member States they are the dominant distribution channel.[49] However, European banks' share of non-life distribution is small, ranging from 3% to 11% in one survey.[50]

In general, European banks' involvement in 'business insurance' is small and is confined mainly to the distribution (and only occasionally the underwriting) of policies covering small business risks.

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[46] However as Doman *et al* observe (note 44 above) the perceived independence of insurance brokers gives them an advantage against insurers in this arena.

[47] Nurullah, M (2002) 'Bankers as Insurers: the European perspective' unpublished paper based on PhD thesis.

[48] Nurrulah, quoted in note 47 above.

[49] Nurrulah (quoted in note 47 above) found that banks in Portugal, Spain, France and Italy account for over 60% of life insurance distribution and only in the UK and Netherlands are they relatively insignificant, with market shares of 10.2 and 21% respectively.

[50] Nurrulah, quoted in note 47 above.

V. MARKET INTEGRATION[51]

1. BENEFITS OF INTEGRATION

An integrated EU insurance market offers benefits to both insurers and their clients. First, insurers benefit from an improved regional diversification of insured risks. This reduces the likelihood of a large accumulation of losses from one event (such as a storm or flood) affecting a major proportion of risks in the same portfolio. It may also have other smoothing effects, such as in dampening the volatility of the insurance cycle.[52] Other benefits include the possible realisation of economies of scale and scope and a wider area for investing assets. Clients should benefit from a wider choice of insurance suppliers, a higher degree of competition and, to the extent that efficiency gains made by insurers are passed on, lower prices from that source also. Clients might also benefit from a broader choice of insurance contracts as a consequence of competitive innovation by insurers and the availability of products developed in foreign markets but not previously available, though the availability of the latter may depend upon the mode of market entry by the insurer. This is discussed below.

2. THE EXTENT OF INTEGRATION IN THE EU INSURANCE MARKET

One indicator of integration is the level of penetration of the EU insurance markets by foreign (EU) insurers and the corresponding possibility for consumers to access foreign insurers. This penetration/access takes three basic forms:

1. direct cross border sales by insurers without local establishment in the territory of the consumer (operation on a services basis);
2. sales through locally established branches or agencies;
3. operation in foreign markets through locally established subsidiaries, which may be:
    (a) set up as 'greenfield' investments;
    (b) the result of merger or acquisition activity.

2.1 Models of integration

A recent analysis by the European Commission's DG Internal Market and Services[53] describes three competitive structures, as follows, namely:

- **Competition within national markets**, where markets are organised within national boundaries;
- **Competition on an EU-wide basis**, where competition takes place in a fully or well integrated market, and where companies operate in several EU countries either through branches or directly via cross-border provision of services;
- **Multi-domestic competition with cross-border entities**, where customers are confined to their national markets, which are dominated by a few, large companies. Some of these companies are, or are part of, pan-European groups.

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51 For a more detailed analysis of the state of integration of the EU-insurance market, cf. the annual publications of DG Internal Market and Services *"Financial Integration Monitor" 2004, 2005 and 2006:* http://ec.europa.eu/internal_market/finances/fim/index_en.htm. In the 2006 edition, a special feature was dedicated to the insurance sector.

52 Though the benefits may be limited in this respect, as the peaks and troughs of underwriting cycles appear to coincide quite closely across national insurance markets.

53 DG Internal Market and Services *Financial Integration Monitor 2004*, pp. 13-14. See http://ec.europa.eu/internal_market/finances/docs/cross-sector/fin-integration/sec-2004-559_en.pdf.

This latter structure, which can be described as a 'partly integrated market', is the structure that characterises the EU insurance markets at present: consolidation takes place mostly on a cross-border basis through acquisitions, resulting in significantly increased concentration levels at EU level. From a company perspective, an important share of business takes place in countries other than the home country. From a customer point of view, choice does not improve, as there is little if any cross-border provision of services. However, customers may still benefit indirectly from the effects of consolidation of these pan-European insurers, to the extent that the achieved efficiency gains may be forwarded to the customers.

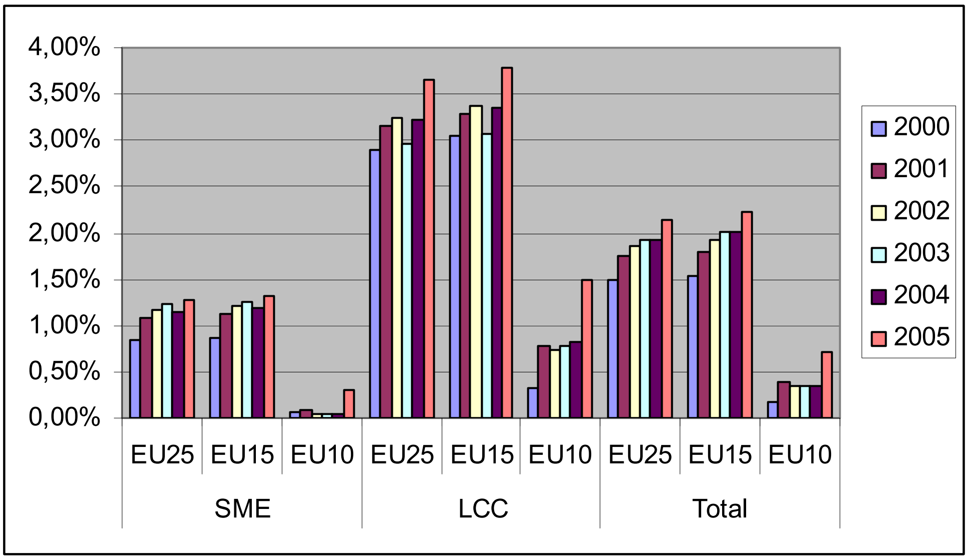
The various forms of foreign penetration are now considered in more detail, beginning with cross-border sale of insurance.

2.2 Cross border sale of business insurance

The questionnaires sent to insurance companies from EU-25 in the context of the sector inquiry tackled the issue of cross-border sales of business insurance. Of the companies that have international operations, 65% declared that they sold business insurance through cross-border provision of services[54].

But as we see in figure V.1 which shows the percentages of cross border business over total premiums written for our sample and for business insurance only[55], cross border business for EU-25 is low: it varies between 1.5 % and 2.2% of gross premiums written in 2000-2005 and it is lower in EU-10 than EU-15. We can also see that the percentage of cross border sales is much lower for SME customers than for large commercial clients (LCC).

Figure V.1 - Cross-Border Sales of Business Insurance by free provision of services in % of total premiums written



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

[54] The question was asked to each company at group level. The companies had moreover to answer for all subsidiaries of their group in the EU-25. This means that two companies belonging to the same group have answered identically and for all the subsidiaries belonging to their group. In the calculation of the aggregate numbers over EU-25, we have taken into account only one company answer per group, and we have included all the subsidiaries.

[55] The individual percentages per company were weighted by gross premium written.

On the distribution side, we asked brokers about the use of foreign insurers to offer cover to domestic clients. 65% of the brokers in our sample (covering 14 EU Member States[56]) reported placing insurance in 2005 on behalf of domestic clients with insurers that were located in a different Member State than the one where the broker was located. Of this group, 67% placed such business without any other intermediary, 44% used an intermediary belonging to the same group and 52% used an intermediary not belonging to the same group[57]. However, the amount in terms of premiums of such business placed is very small on average: respectively 3.49%, 0.56% and 0.19% of total annual premiums placed (excluding non-EU wholesale business; the amounts of premiums were weighted by the total revenue of brokers).

2.3 Sales through branches and agencies

The data on the extent to which insurers in various EU Member States make use of branches and agencies is limited. However, OECD figures give an indication of the significance of this form of penetration in a number of EU Member States, including all the large non-life markets (see Table V.1).

Table V.1 - Market share of branches/agencies of foreign undertakings in total domestic non-life business 1994-2003 (percentage)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	**2003**
Austria	0.16	0.17	0.16	0.17	0.14	0.16	0.19	0.22	0.15	**0.24**
Belgium	2.92	2.34	2.57	2.46	2.57	2.59	2.59	2.67	2.54	**2.27**
Czech Rep.	0.87	0.68	1.10	1.44	1.07	1.38	2.28	2.81	2.22	**0.75**
Denmark	3.42	2.43	1.80	1.73	1.81	1.62	1.59	-	na	**0.02**
Finland	0.44	0.12	0.12	0.13	0.13	0.24	0.31	-	0.29	**0.35**
France	1.35	1.35	1.35	1.24	1.23	1.04	1.00	0.97	0.49	**0.24**
Germany	1.53	1.11	0.70	0.66	0.67	0.67	0.66	0.68	0.72	**0.51**
Greece	10.91	10.67	10.13	10.25	9.82	8.26	7.32	4.91	3.53	**5.26**
Ireland	24.86	18.07	19.68	16.05	16.75	16.54	13.33	14.37	na	**8.61**
Italy	2.80	3.67	3.86	4.53	4.83	5.57	6.73	6.94	6.95	**7.07**
Luxembourg	18.71	15.91	15.79	14.94	12.34	10.01	na	10.06	6.73	**13.13**
Netherlands	5.11	3.06	2.56	2.50	2.41	2.12	1.86	1.91	na	**na**
Poland	na	na	na	na	-	-	-	-	0.01	**0.13**
Portugal	3.67	0.70	0.71	0.74	0.78	0.05	na	0.08	0.10	**0.12**
Spain	6.67	3.77	3.19	3.38	0.06	0.07	0.70	0.09	0.06	**0.10**
UK	6.35	6.25	6.60	7.40	10.90	9.93	15.23	19.82	15.01	**9.02**

Source: OECD Insurance Statistics Yearbook 1994-2003 © OECD 2005

The OECD data indicate that only a small share of total non-life business in the countries represented is conducted by branches and agencies of foreign insurance companies. Among the large EU markets branch and agency business is significant and growing only in Italy and the UK. Conversely, in most other countries the significance of branches and agencies is declining.

[56] Belgium, Denmark, Estonia, Finland, France, Germany, Hungary, Italy, Netherlands, Poland, Portugal, Spain, Sweden, United Kingdom (see chapter II).

[57] The totals do not add up to 100% as the same broker can use the different methods.

2.4 Penetration of foreign markets through M&A activity or 'Greenfield' investment

The preferred method of entering a foreign insurance market is through a subsidiary. Usually, this is done through a take-over or acquisition of a majority stake in a local insurer rather than through the establishment of a foreign subsidiary via a 'greenfield' investment.

The recent increase in the level of M&A activity among European insurers, including the rise in cross-border deals[58], has resulted in an increasing penetration of EU insurance markets by foreign insurers.

The latest available figures from the OECD, summarised below (Table V.2), give a picture of the overall market share of foreign insurance companies in the domestic non-life market of a selection of EU countries. The figures comprise the market share of foreign controlled companies plus the market share of branches and agencies of foreign companies, summarised in the previous table.

Table V.2 - Overall non-life market share of foreign companies in the domestic market of selected EU Member States 1994-2003 (percentage)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	**2003**
Austria	49.25	47.60	49.34	49.16	50.85	48.83	48.71	44.57	48.80	**na**
Czech Rep.	20.66	25.63	30.03	28.43	28.09	28.78	42.93	81.02	83.82	**88.48**
Denmark	22.15	32.84	30.86	28.64	30.17	43.67	42.91	37.38	na	**17.24**
Germany	7.83	7.30	13.08	12.70	12.21	13.60	13.40	14.27	12.95	**12.63**
Hungary	93.96	92.30	91.01	90.93	91.79	90.68	na	90.37	89.24	**na**
Italy	na	na	na	na	na	na	na	na	37.01	**32.68**
Luxembourg	na	na	36.03	31.74	25.56	23.94	na	22.60	18.81	**37.40**
Netherlands	23.51	22.29	20.97	36.63	36.69	35.81	na	na	na	**na**
Poland	na	na	na	na	12.06	16.25	33.35	35.52	37.12	**38.53**
Portugal	9.12	15.35	14.94	15.03	26.4	26.71	na	29.94	28.50	**26.16**
Slovak Rep	na	na	na	31.36	26.78	na	37.92	37.74	96.79	**97.45**
Spain	32.10	33.09	29.32	27.29	26.65	25.18	26.03	29.13	23.01	**21.25**
UK	na	na	na	37.34	39.91	44.45	49.70	57.80	48.43	**42.98**

Source: OECD Insurance Statistics Yearbook 1994-2003 © OECD 2005

The analysis of foreign penetration of EU insurance markets provided by Swiss Re,[59] distinguishes between domestic insurers ('Nationals'), foreign insurers ('Foreigners') and a third category of European multinational insurers ('Europeans'), which are classified as foreign in countries other than those where the group is domiciled, but which are pan-European in nature. According to Swiss Re, national insurers in the six biggest EU markets lost 15% of their market share between 1990 and 1998 (down from an average of 68% to 53%), and foreign insurers (other than the 'Europeans') also lost 8% of their market share (down from 15% to 7%), while the pan-European groups made a massive gain of 21% (up from 18% to 39%).

[58] Cf. chapter IV. See also European Commission DG Internal Market (2005) 'Financial Integration Monitor 2005 (Addendum)' for a detailed analysis of cross-border consolidation in the insurance and other financial services sectors between 1999 and 2004.

[59] Swiss Re, *sigma* No. 3/2000, cf. chapter IV.

2.5 Conclusion

As shown above, the preferred method of market entry remains market entry via a subsidiary, preferably through the acquisition or take-over of a majority stake in a local insurer. This enables the acquiring company to gain market share in the territory concerned and to buy knowledge and experience of local market conditions and preferences. Moreover, the physical presence of company staff and resources in the territory concerned can be useful in some lines of business, because it enables insurers to carry out more easily inspections of complex risks for underwriting purposes and for claims settlements.[60] This need for physical presence is unique to insurance, and has no equivalent in banking and other financial markets.[61]

On the other hand, penetration of a foreign market via the acquisition of a local firm could deny customers new or alternative insurance products that they might have access to if the firm concerned chose rather to exploit the market through a branch or agency or via cross border sales or through a greenfield investment. However, it may be that differences in the products marketed by such a foreign firm in its own country, and denied to customers of the subsidiary, arise not because the foreign insurer is more innovative than local firms, but largely because they were developed for different market conditions. If such products were offered, unchanged, in a foreign market, they might not be innovative but simply unsuitable.[62]

3. FACTORS GOVERNING THE MARKET BEHAVIOUR AND MARKET ENTRY STRATEGY OF INSURANCE FIRMS[63]

Insurers that had entered the market of another EU Member State during the past 10 years were asked in the questionnaire to mark (scale 0 to 10) and rank different factors governing market entry. Figure V.2 gives the average mark per factor (average not weighted)[64].

The answers obtained suggest that the main drivers for entering another market are "Potential for growth of the market", "Perceived profitability of the market or line of business", "Size of the market" and "Access to distribution infrastructure" (the latter being facilitated through the acquisition of a foreign insurer). By contrast, tax (dis)advantages, differences in tort law/ damages and contract law seem to be less important (they obtained the lowest mark in the list we proposed to insurers).

It should be noted that the three prime factors mentioned are also the ones that are considered the most important ones when an insurer decides to exit a market (figure V.3), albeit in a different order of importance (it has to be noted that insurers were asked what was the main reason for a market exit and they could only point out one factor). The "profitability of the market or line of business" was mentioned as the most important reason for market exit for 67% of those exits, followed by the "potential for growth of the market" and the "size of the market".

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60 Of course, such inspections can be outsourced or carried out via local representatives or independent loss adjusters, even if the insurer has no physical presence.

61 Equally, the wholesale nature of reinsurance business makes the physical presence of the reinsurer unnecessary in the territory of the reinsured risks.

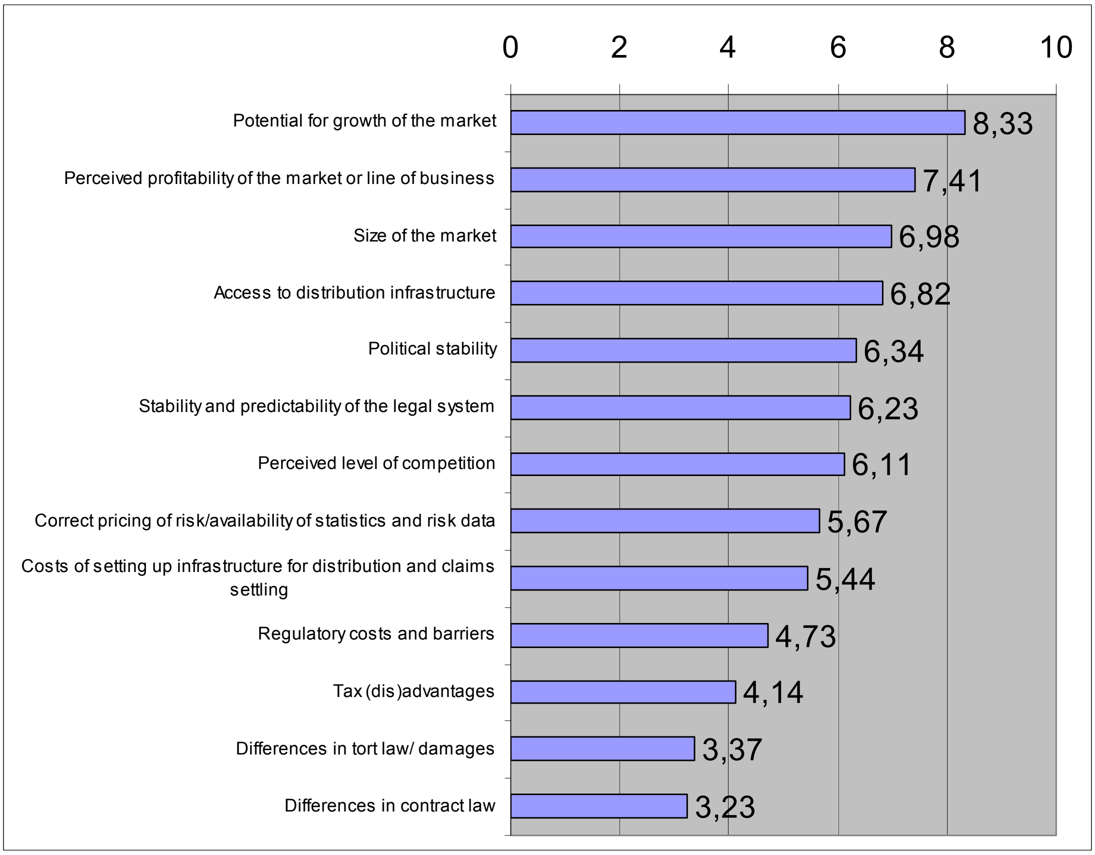
62 For example when US insurers first started to market their D&O insurance products in EU countries where deregulation and other changes made them appear ripe for development, the initial result was the offering of products based on US law, terminology and corporate structures that were quite unsuited to most EU Member States.

63 In this section, results are given for questions asked to companies at group level (which implies that two companies from the same group have identical answers). In the calculation of the aggregate numbers for EU-25 or for the sample of 14 countries for brokers, answers from each group have been taken into consideration only once.

64 Averages were not weighted in all this section.

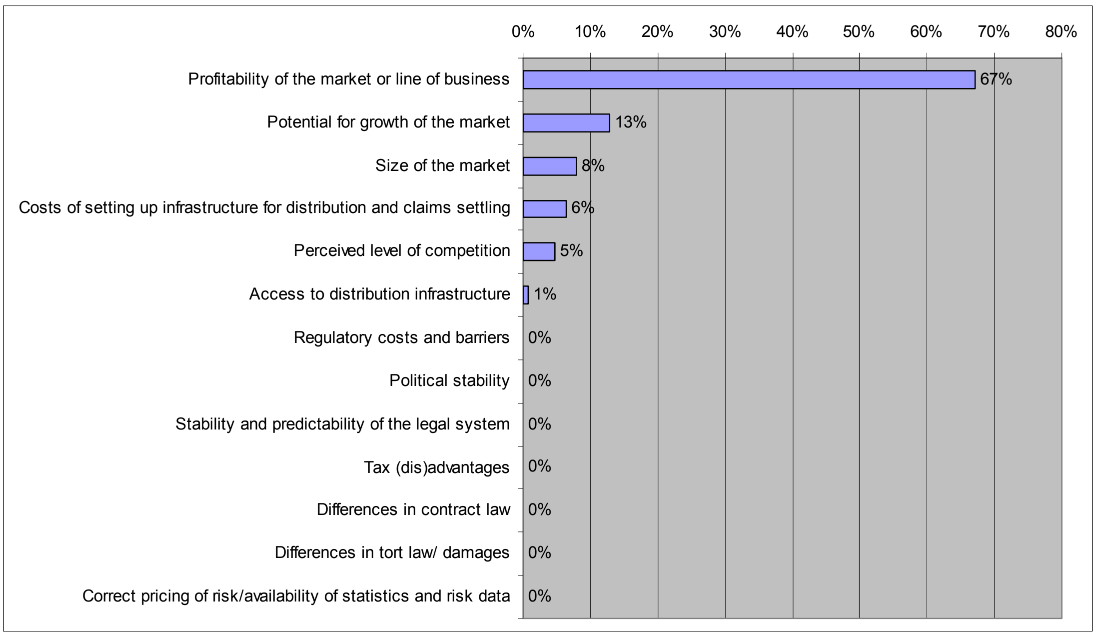
"Costs of setting up infrastructure for distribution and claims settling" is the fourth reason for exit. This indicates again the importance of the distribution network for foreign insurers.

Figure V.2 - Factors influencing market entry by insurers



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

Figure V.3 - Factors having influenced market exit by insurers

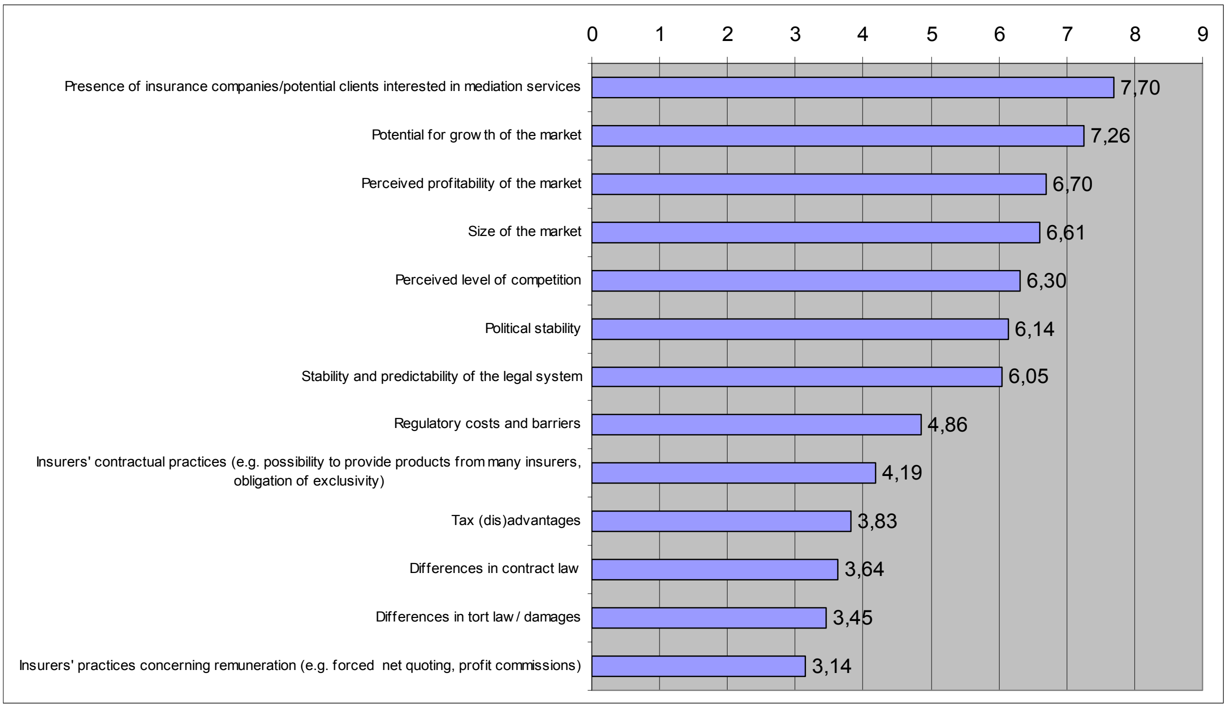


Source: European Commission, Business Insurance Survey 2005-2006.

Similar questions regarding drivers for market entry and market exit were asked to brokers. For them the main factor for market entry was the “presence of insurance companies/potential clients interested in mediation services”. However, it is interesting to see that otherwise the brokers are motivated by the very same main reasons as the insurance companies. Likewise, tax (dis)advantages, differences in tort law/ damages and contract law also have low marks. See figure V.4.

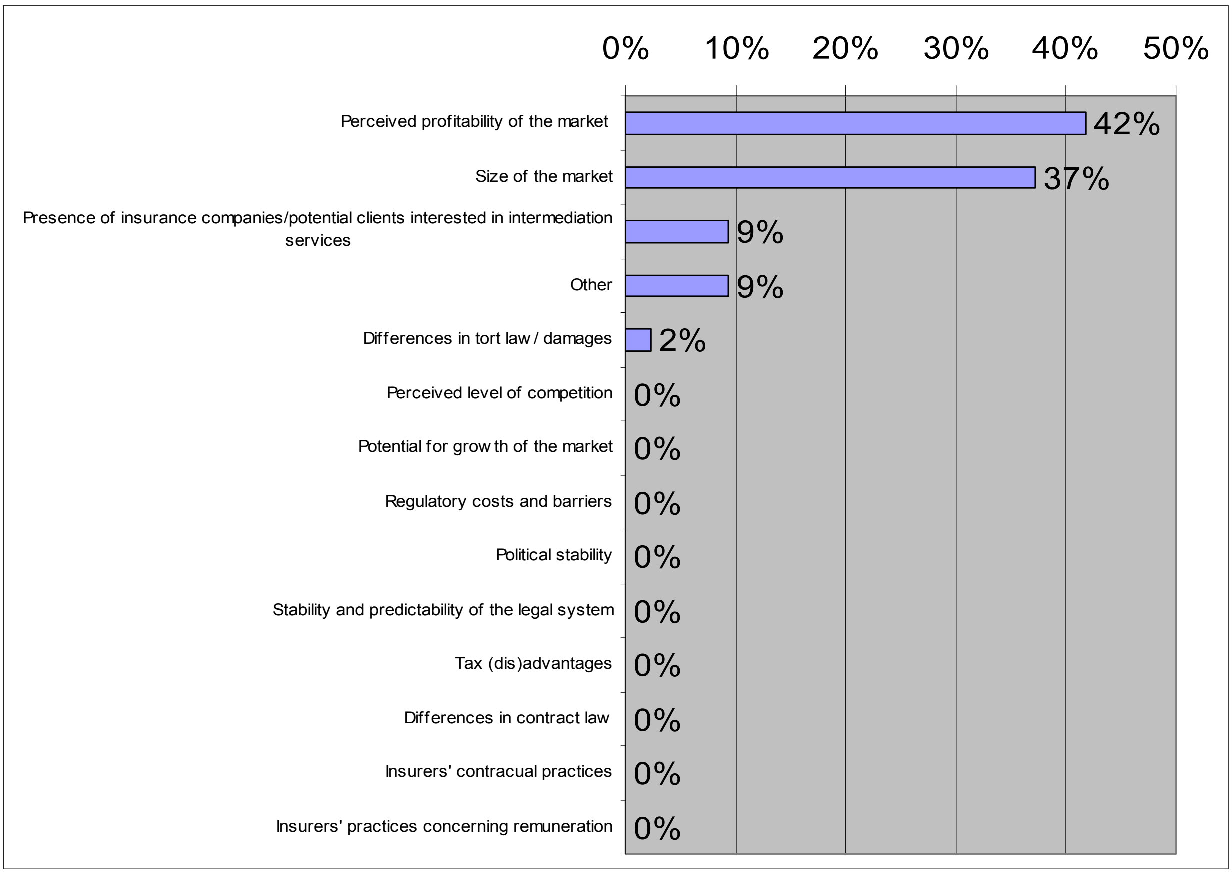
As regards the main reason for market exit, brokers stated the “perceived profitability of the market” and “size of the market” (almost 80 % of reasons for exit). See figure V.5.

Figure V.4 - Factors influencing market entry by intermediaries



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

Figure V.5 - Factors having influenced market exit by intermediaries



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

4. CONCLUSIONS

Among the different ways of penetrating/accessing foreign markets in the EU, the preferred method is through a subsidiary, usually acquired through an acquisition or a take-over. Following a classification from the European Commission's Directorate General for Internal Market and Services, we can describe competition in the EU insurance market as a multi-domestic competition with cross-border entities, where customers are confined to their national markets, which are dominated by a few, large companies (some belonging to or being part of pan-European groups).

Interestingly, the inquiry shows that for the insurers, the factors influencing their decision to enter a new market are primarily financial and commercial factors (profitability, potential for growth of the market, size of the market) but the next important factor is the access to distribution infrastructure. This access is more relevant for them than the differences in legislation or tax regimes (the brokers also rate the latter factors among the least important ones for market entry). Some insurers even quote the cost of setting up an infrastructure for distribution and claims settling as being the main reason for having exited a market.

VI. FINANCIAL ASPECTS OF THE INDUSTRY

1. Introduction

Ideally assessment of the degree of competition in the EU business insurance market would require a comparison of insurance prices and associated costs for various lines of insurance in different Member States. Unfortunately, there are no adequate indices of insurance prices that would allow 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 as seemingly similar “insurance products” may be of a very different nature. For example, the scope of coverage and policy conditions will often vary significantly from one country to another, especially for liability insurances, and claims costs will also differ. However, it is quite easy to measure and compare premium income at a portfolio level for different markets, insurers and lines of business. An alternative approach in attempting to compare insurance prices is thus to rely on indirect measures.

Moreover, looking at the profitability of businesses may also yield important information for competition analysis. In fact, while the existence of significant profits may be the rewards for taking risks and innovating, superior efficiency or better management, they could also be the result of having and exerting market power. High and persistent profits in relatively mature markets may suggest the latter. These findings, together with other evidence provided by this inquiry on possible barriers to competition, may enable one to ascertain whether a firm or a group of firms is exercising market power to the detriment of consumers in a particular market.

This section therefore provides a descriptive comparison of profitability trends of the insurance business for all EU-25 Member States. This analysis covers the period of 2000-2005. In order to investigate this issue at stake, we use a simple and widespread economic measure: the 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 is termed the combined ratio and measures the amount that an insurer must pay to cover claims and expenses per Euro of earned premium. It is a suitable competitive benchmark because 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 underwriting loss and if less that 100% it is making underwriting profits. A ratio significantly below 100% might thus imply the existence of economic profits resulting from the exercise of market power. Accordingly, a ratio of 95 % means the insurer has made five cents of underwriting profit for each premium Euro.

The combined ratio may suffer from a certain number of drawbacks. First, when claims are more likely to arise 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 all expenses are paid. This is an important source of insurance companies’ revenue. 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[65].

[65] 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. Capital losses can also occur, which reduce overall investment performance. The sum of what insurers earn in interest from their

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[66]. Finally, the risk covered by underwriting may be different in the different lines, and therefore the return on capital demanded may be also different. Although the economic ratio may suffer from all drawbacks, it presents the advantage of being a simple and widespread economic measure used to measure the profitability of the industry.

The industry profitability measurement is usually broken down into the combined ratio and the net investment results. Companies were not required to provide net investments results for the purpose of the inquiry. However, in light of the evidence provided by the industry, it seems straightforward to conclude that if the UK insurers, for instance, display an average combined ratio of 100%, the average profit margin amounts to 16% in this Member State.

Stakeholders seem to agree widely that underlying profits shouldn't magnify *significantly* the investment results. As an industry expert consulted by DG Competition indicated, annual combined ratios, which are regularly, significantly lower than 100% may be a strong indication that insurance companies are exerting market power. It should be noted, however, that the objective of the profitability analysis is not to define "reasonable" and "excessive" profits. The objective of this analysis is to assess market power using profit as a proxy.

The measurement of profitability of a specific activity is typically subject to problems related to the allocation of costs that are common to other activities. This could also be relevant in our 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 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 country disparities. 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 incurred 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. 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.

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bond portfolio, plus stock dividends and capital gains (less capital losses) is known as the industry's investment gain.

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

In this chapter, we therefore analyse:

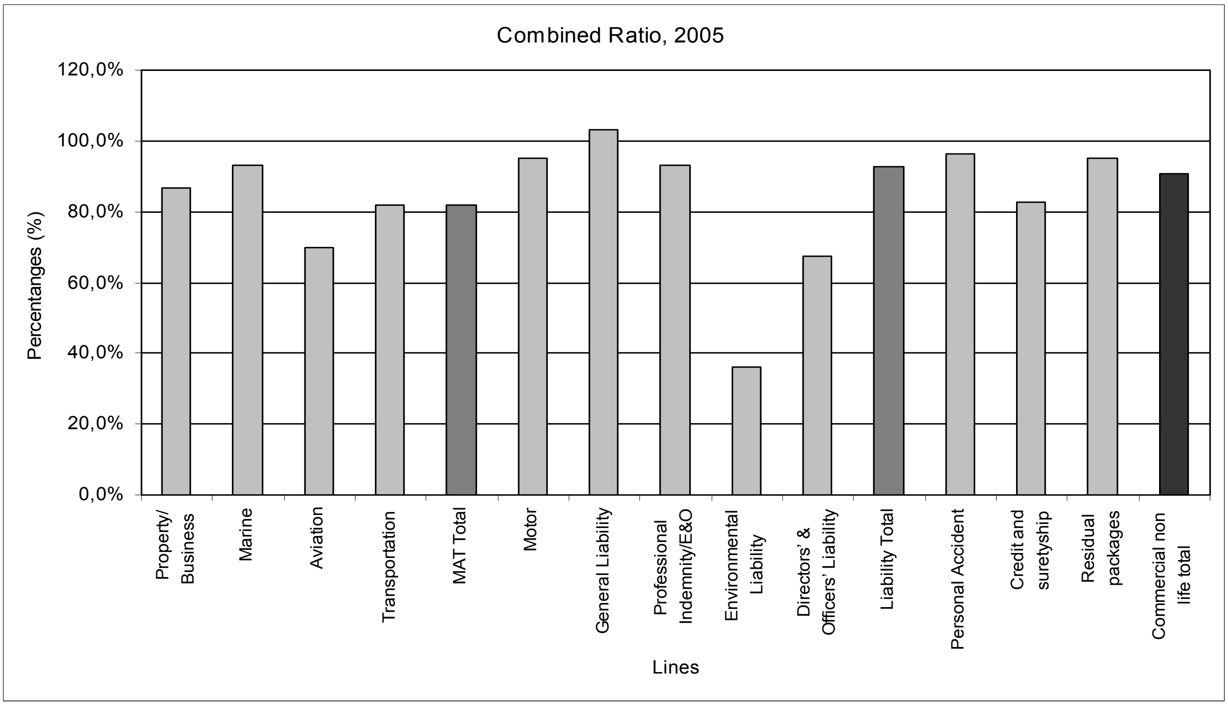
- The combined ratio of business insurance of individual lines of business (for the entire EU 25 and per country).
- The loss and the expense ratio of individual lines of business (for the entire EU 25 and per country).
- The combined ratio, loss ratio and expense ratio split between Large Companies and SMEs

2. Combined ratios

Figure VI.1 displays the level of aggregated combined ratios in the 12 lines of business for 2005 for all respondents (at the EU-25 level) plus three aggregate categories of business lines. These aggregate categories are "MAT" - which encompasses Marine, Aviation and Transport; "Liability Total", which includes all liabilities lines; and, finally, "Commercial non-life Total" which encompasses all commercial non-life activities.

It is worth noting that, when computed at the EU-25 or Member-State level, aggregate combined ratios are weighted averages of all sampled insurance companies located in a specific country and active in a particular line (the weight is given by the company's total written premium in that line). Weighted averages provide a more accurate picture of the overall profitability, as they avoid weighting equally small and large insurance companies in the determination of aggregated combined ratios.

Figure VI.1 – Weighted combined ratios, EU-25, 2005



Source: European Commission, Business Insurance Survey 2005-2006

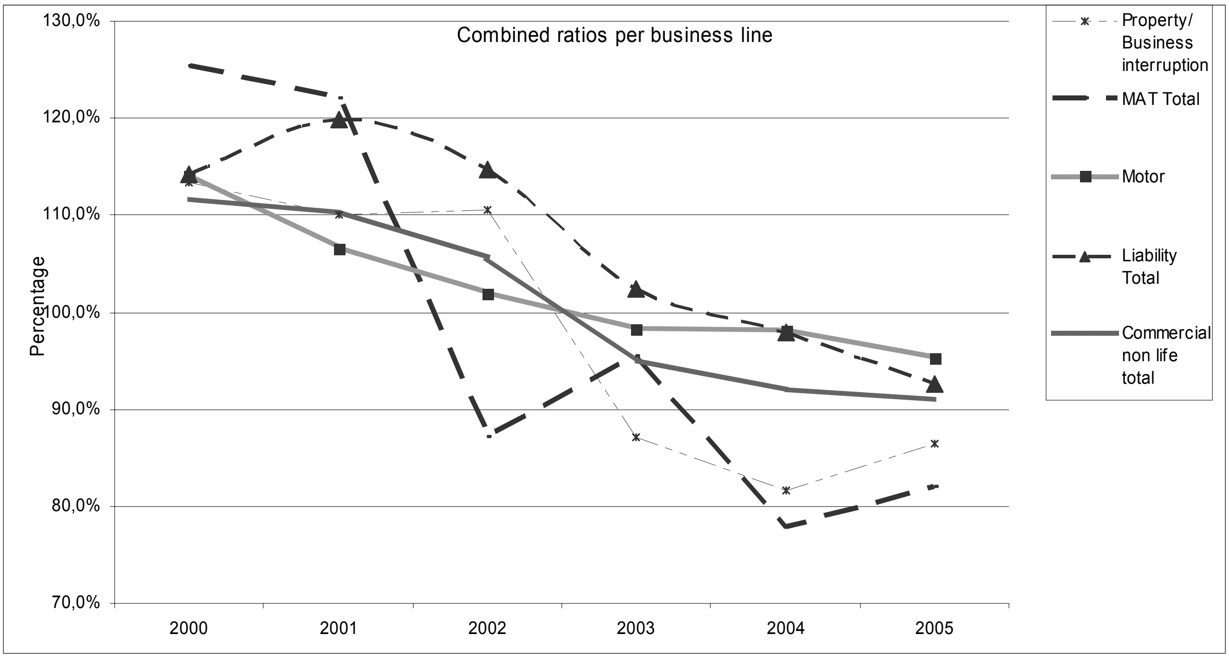
The distribution illustrated in Figure VI.1 reveals that only 1 out of 12 lines of insurance businesses at the EU-25 level displays a combined ratio higher than 100%. Reported figures show also a significant variation across lines. For instance, the combined ratio of Environment Impairment Liability amounts to 36%, while the equivalent figure for Motor is 95%. In other words, the underwriting profit for each premium Euro is on average 64 cents for Environment

Impairment Liability and 5 cents for Motor. This differential is less pronounced, but still significant, between Motor and other lines such as Property and Business Interruption (85%).

It is worth noting that the aggregated item "Total commercial non-life business" displays a weighted combined ratio of 91%. If one generalizes the average annual net investment results of the non-life insurance industry reported by Swiss Re (op. cit., 2006,) in the UK, Germany, and France over the period 1994-2004 (16%) to all European economies, it can be concluded that business insurance is a profitable activity in the EU with a pre-tax average profit margin of 25%.

For the sake of simplification, only the dynamics of the ratios of the three aggregate items - "MAT", "Liability Total" and "Commercial non life Total" - plus that of two main individual insurance businesses (Property/business interruption, and Motor) are depicted in Figure VI.2. These are the main categories of lines of business insurance in terms of industry turnover.

Figure VI.2 – 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. If the analysis of figure VI.2 illustrates how combined ratios have consistently decreased since 2000 in all four lines, Table 1 confirms that nearly all the 12 lines had falling levels of combined ratios over the period.

Table VI.1 - Weighted combined ratios all lines (%), EU-25, 2000-2005

Lines\Years	2000	2001	2002	2003	2004	2005	2000-2005
Property/ Business interruption	113%	110%	111%	87%	82%	87%	96%
Marine	161%	182%	120%	77%	98%	93%	118%
Aviation	119%	176%	63%	72%	50%	70%	83%
Transportation	111%	104%	96%	101%	84%	82%	96%
MAT Total	125%	122%	87%	95%	78%	82%	96%
Motor	114%	107%	102%	98%	98%	95%	102%
General Liability	127%	137%	110%	110%	106%	103%	113%
Professional Indemnity/E&O	127%	118%	125%	108%	102%	93%	110%
Environmental Impairment Liability	27%	32%	37%	38%	39%	36%	35%
Directors' & Officers' Liability	61%	398%	77%	78%	67%	67%	106%
Liability Total	114%	120%	115%	102%	98%	93%	105%
Personal Accident/Medical Expenses	103%	103%	97%	96%	96%	97%	98%
Credit and suretyship	75%	101%	81%	83%	91%	83%	85%
Residual packages	102%	110%	108%	110%	99%	95%	104%
Commercial non life total	111%	110%	106%	95%	92%	91%	99%

Source: European Commission, Business Insurance Survey 2005-2006

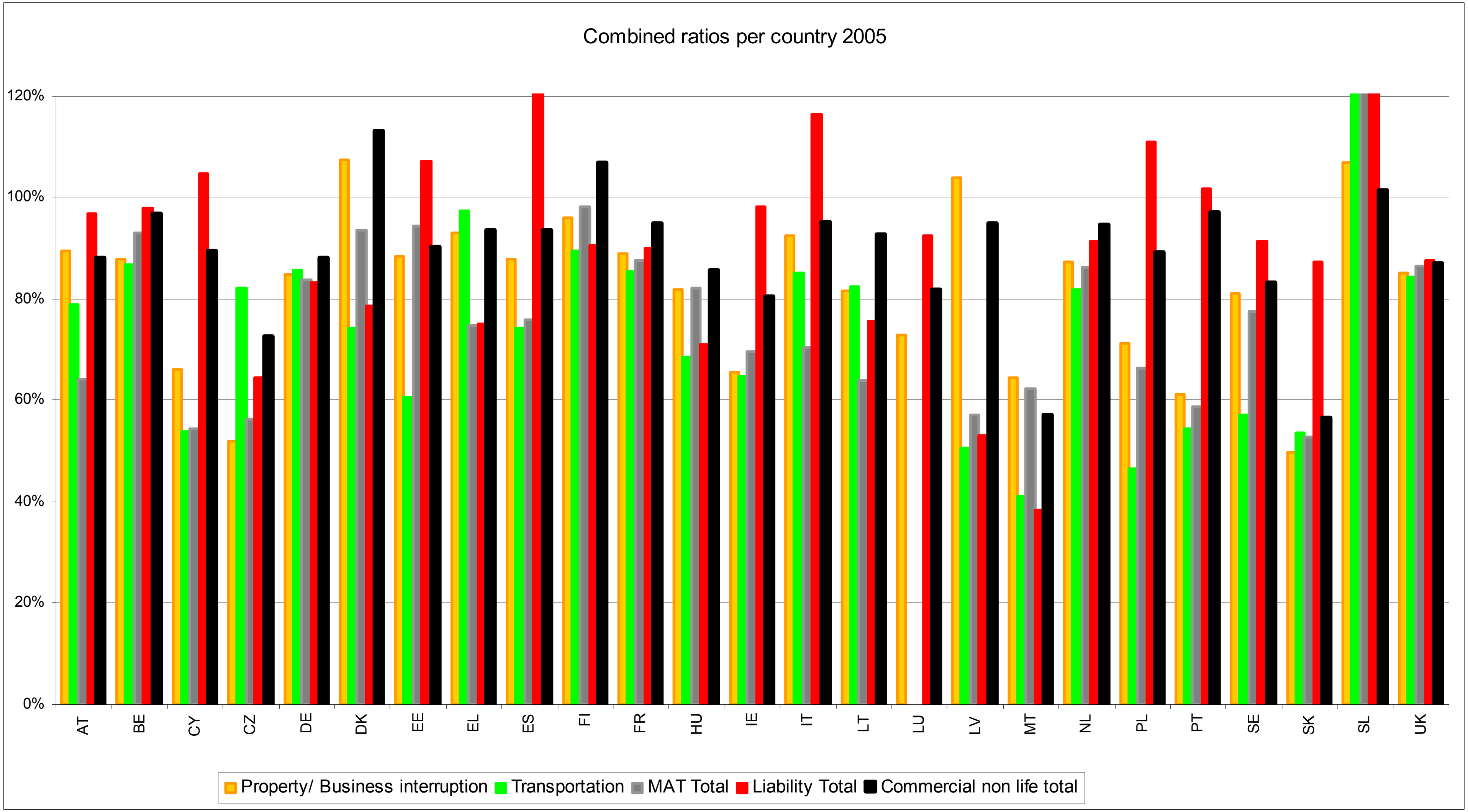
These charts appear to indicate that the market has achieved lower combined ratios over time. This also appears to tie in with earlier observations concerning the initial hardening of insurance markets after "9/11/01" and their subsequent progressive softening in 2003 to 2005.

The need for catastrophe provision 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 explain partially the differential found in combined ratios. However, we cannot rule out the possibility that profits in different line of insurance might be used to subsidise losses in other lines.

The analysis of the underwriting profitability at an aggregated level may mask, however, substantial differences across Member States. Therefore, the analysis of the underwriting profitability at a country level may provide further insight regarding the distribution of combined ratios across lines.

Figure VI.3 illustrates the distribution of the weighted combined ratios of 4 main lines of each of the 25 Member States for 2005.

Figure VI.3 – Weighted combined ratios of main lines, country-level, 2005



Source: European Commission, Business Insurance Survey 2005-2006

Property/business interruption displays a weighted combined ratio less than 100% in 22 out of 25 countries, but these ratios vary significantly across countries – their values range from 50% in Slovakia to 107% in Denmark and Slovenia.

The category that includes Marine, Aviation and Transportation (MAT) has a weighted combined ratio of less than 100% 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 is again a sharp variation in the country weighted combined ratio. It varies from 56 % in Germany to more than 140 % in Slovenia. Motor tends to display higher weighted combined ratios: its overall EU-25 average amounts to 95 %. Again, combined ratios vary significantly across countries. Indeed, the lowest ratio amounts to 38% in Slovakia while the highest ratio is 123 % in Portugal. Liability Total also follows this pattern. For instance, Germany displays a weighted combined ratio of 83% while the equivalent figure for Italy is 116%. When these four lines are compared, Motor displays 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 is less than 100% in 22 out of 25 Member States. The country with the lowest ratio is Slovakia (57%) while Denmark presents the highest ratio (113%).

When the analysis focuses on the differential across lines within countries, the picture is again one of a great disparity. In Ireland, for instance, “Liability Total” generates a combined ratio of 98%, while the equivalent figure for “Property/Business Interruption” is only 68 %. In Slovenia, this difference is even greater: “Liability Total” has a ratio 40 points higher than that of “Property/Business Interruption”. This picture of great disparity across these lines within countries is common to all almost EU-25 Member States. While relatively lower combined ratios of Malta, Cyprus and Latvia need to be assed carefully as they are based on a limited number of observations per line, the overall results show thus that there are significant differences across countries within the same lines.

Another interesting finding relates to the comparison between EU-10 and EU-15. All lines display consistently and significantly lower ratios in the New Member States than in the EU-15. Indeed, the weighted combined ratio for the New Member States and EU-15 is, 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) then the matching principle of accounting is not satisfied for the ratio because clients "pre-pay" their insurance. In this situation, it is normal to collect more premia today when the market is growing. Therefore, we would expect lines which have this property to show a lower combined ratio when underwriting is growing. This might explain to a certain extent the difference on the ratios found for the EU-10 and the EU-15

Table 2 presents the combined ratios for all 12 lines surveyed by the inquiry computed at the country-level.

Table VI.2 - Weighted combined ratios all lines (%), country-level, 2005

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
AT	90	18	77	79	64	99	96				97	96			88
BE	88	105		87	93	97	101	102	97	70	98	106	250	84	97
CZ	52	39	30	82	56	88	70	45	52	24	65	94	149	70	73
DE	85	-2	40	86	84	97	79	106	14	62	83	100	82	101	88
DK	107	116	128	74	94	91	91	106	15	6	79	110	-2	82	113
EE	88	143		61	94	89	116	34			107	80	29		90
EL	93	132	1	97	75	105	124	25			75	65	119		94
ES	88	75	39	74	76	96	134	103	85	87	134	60	95	99	94
FI	96	112	72	90	98	115	94	61	18	26	91	109	15	113	107
FR	89	104	78	86	88	104	93	44	0	47	90	108	85	109	95
HU	82	57	163	69	82	95	81	81	71	116	71	86	54		86
IE	66	80	26	65	70	74	98	101		58	98	116	69		81
IT	93	72	48	85	70	93	114	133	38	54	116	96	82	120	95
LT	82	17		82	64	99	67	44			76	103	15		93
LU	73			-4	-4	91	105	42		33	93	58			82
LV	104	251	23	51	57	92	45	36		26	53	93	44	86	95
NL	87	72		82	86	112	94	84	84	109	91	96			95
PL	71	95	59	47	66	98	101	150		67	111	76	69	113	89
PT	61	85	35	54	59	123	104	84		0	102	103	131	85	97
SE	81			57	78	91	185	188	82	74	91	94		103	83
SK	50		53	54	53	38	87	49			87	0	111		57
SL	107	253	124	121	143	89	165	61		38	148	91	-105		102
UK	85	120	78	84	87	94	91	81	62	70	87	87	65	87	87
EU-15	87	93	70	83	83	97	103	93	36	68	93	97	84	96	91
NMS	68	95	65	60	68	86	86	98	63	-25	86	88	70	82	81
EU-25	87	93	70	82	82	95	103	93	36	67	93	97	83	95	91

Notes: 1- Property/ Business interruption; 2 - Marine; 3 - Aviation; 4 – Transportation; 5 - MAT Total; 6 – Motor; 7 - General Liability; 8 - Professional Indemnity/E&O; 9- Environmental Impairment Liability; 10 - Directors' & Officers' Liability; 11 - Liability Total; 12 - Personal Accident/Medical Expenses; 13 - Credit and suretyship; 14 - Residual packages; 15 - Commercial non life total.

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

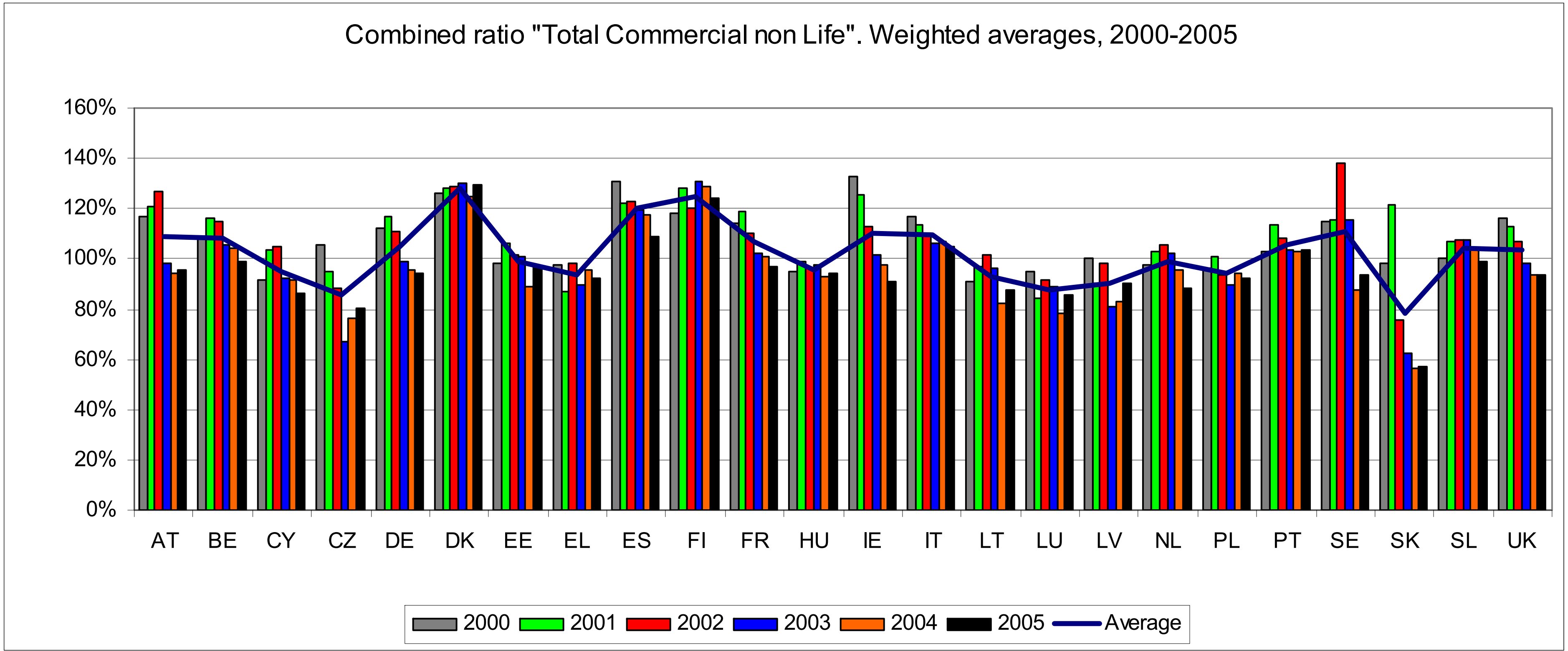
This table confirms there are wide variations in insurers' income for virtually all specific product lines within the same country[67].

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

Figure VI.4 reports the weighted profit ratios by country over the period 2000-2005. Malta was dropped due to data limitations.

[67] Cyprus and Malta were dropped due to confidentially reasons.

Figure VI.4 – 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 the pattern of the "Total Commercial Non Life" is relatively consistent over this period in a large number of countries. These results suggest that the magnitude of combined ratios is not very volatile over the medium-term trend in the majority of the Member States, i.e., Member States tend to display high or low combined ratios throughout the period.

All in all, the results suggest that there is a significant and consistent variation of profitability across product lines and countries over time. The size of these differentials seems to indicate the potential scale for price reduction in parts of the EU-25. This might indicate lack of competition in some market segments or that profits in different line of insurance might be used to subsidise unprofitable lines.

3. Loss and Expense ratios

To get further insights into the sources of underwriting profitability, the combined ratio is decomposed into Loss and Expense ratios. The Loss ratio relates the largest of the cost components of insurers – the amount of claims experienced – to the total of net premiums earned. It is given by the formula:

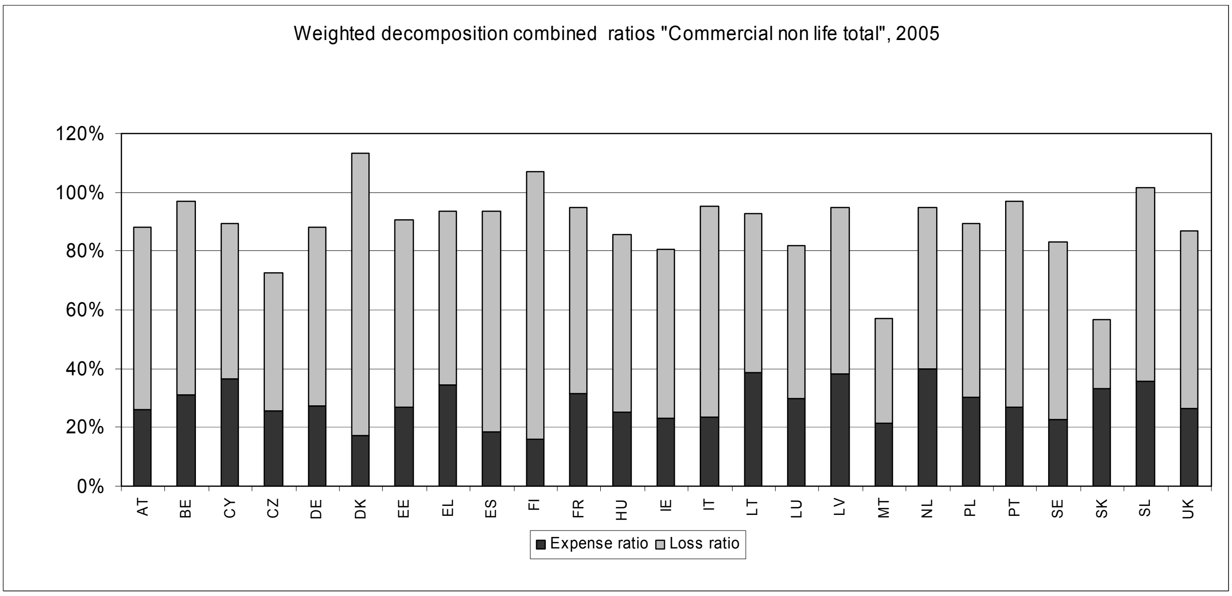
Incurred losses ÷ earned premiums.

The Expense ratio relates the insurers' general expenses - such as general administration (e.g., salaries), marketing and litigation costs - to the total net of premiums earned. It is given by the formula:

Expenses (excluding losses) ÷ earned premiums.

These two ratios are thus two types of industry cost measures. Figure VI.5 shows the decomposition of the combined ratio into Loss and Expense ratios for the aggregate item "Commercial non life Total" for 2005.

Figure VI.5 – Decomposition of combined ratios into loss and expense ratios, country-level, 2005



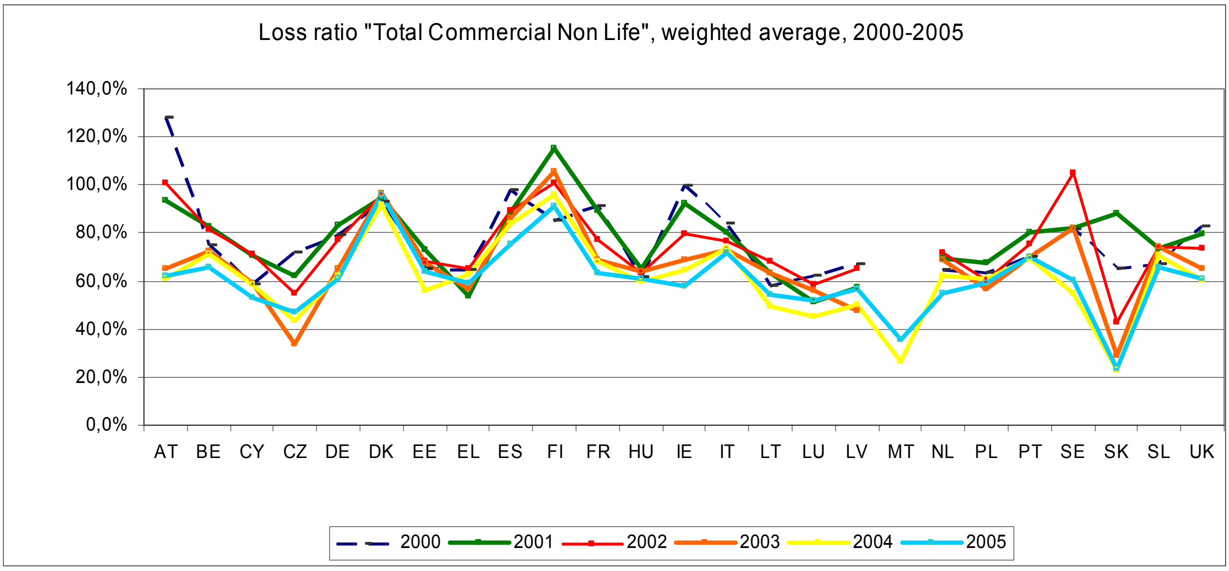
Source: European Commission, Business Insurance Survey 2005-2006

This decomposition reveals that the cost bases of insurances companies vary considerably across the EU-25. For instance, the total expenses incurred by Dutch, Lithuanian and Slovenian insurers amount to more than 35% of the premiums earned but 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%.

It is also of interest to analyse how these cost patterns have evolved over the period considered by the inquiry. One should expect that loss related to claims be more subject to business cycles as it might vary not only with events that occur during a particular calendar year but also with the funds set aside to pay claims that occurred in the past, which may turn out to be inadequate and therefore require additional contributions. Unfortunately, the combined ratio does not take into account this aspect of the industry.

Figures VI.6 and VI.7 display the evolution of the Loss and Expenses ratios over 2000-2005, respectively, for the 25 Member States.

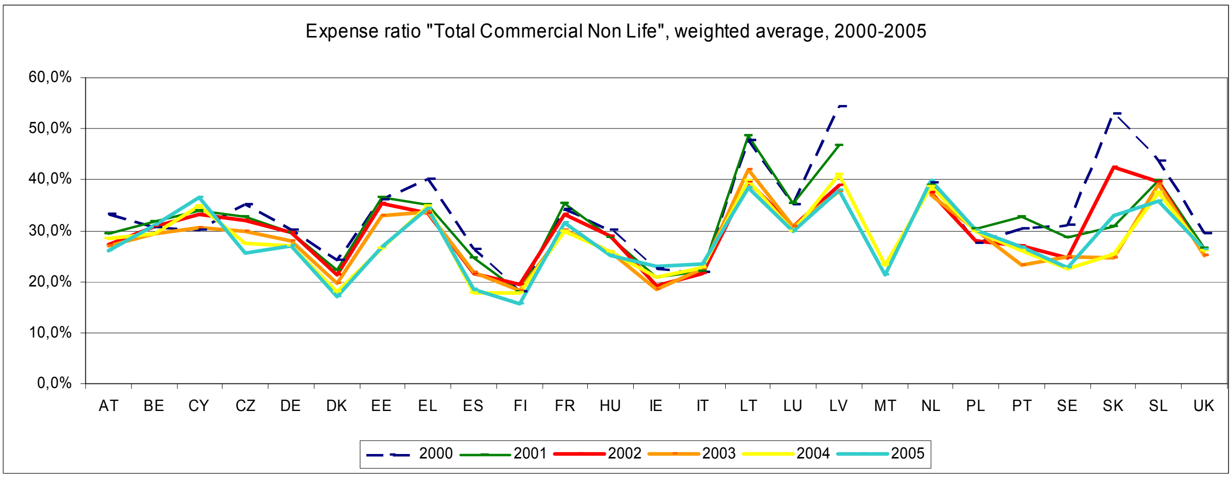
Figure VI.6 – Loss ratio, country-level, 2005



Source: European Commission, Business Insurance Survey 2005-2006

As expected, the Loss ratio (Figure VI.6) presents a higher variation than the Expense ratio (Figure VI.7) over the period in virtually all Member States. Interestingly, the years of 2004 and 2005 seems to display the lowest Loss ratio in almost all Member States.

Figure VI.7 – Expense ratio, country-level, 2005



Source: European Commission, Business Insurance Survey 2005-2006

These figures show that the pattern of the Loss and Expenses ratios has been relatively consistent over time. In other words, Member States tend to display relatively high or low Loss and Expense ratios throughout the period. These findings might suggest that the existing differential on levels of efficiency of the insurance companies constitutes a medium-term trend.

Interestingly, the New Member States tend to display consistently higher Expense ratios than the EU-15 throughout the period 2000-2005. Yet, as mentioned above, the New Member States display consistently higher combined ratios than the EU-15 for all lines. Reading these two findings together, one might conjecture that less efficient markets are also the most profitable ones in the EU. Moreover, it also shows that the cost base structure between these two groups of countries is significant and it is not converging, which might be a symptom of market fragmentation.

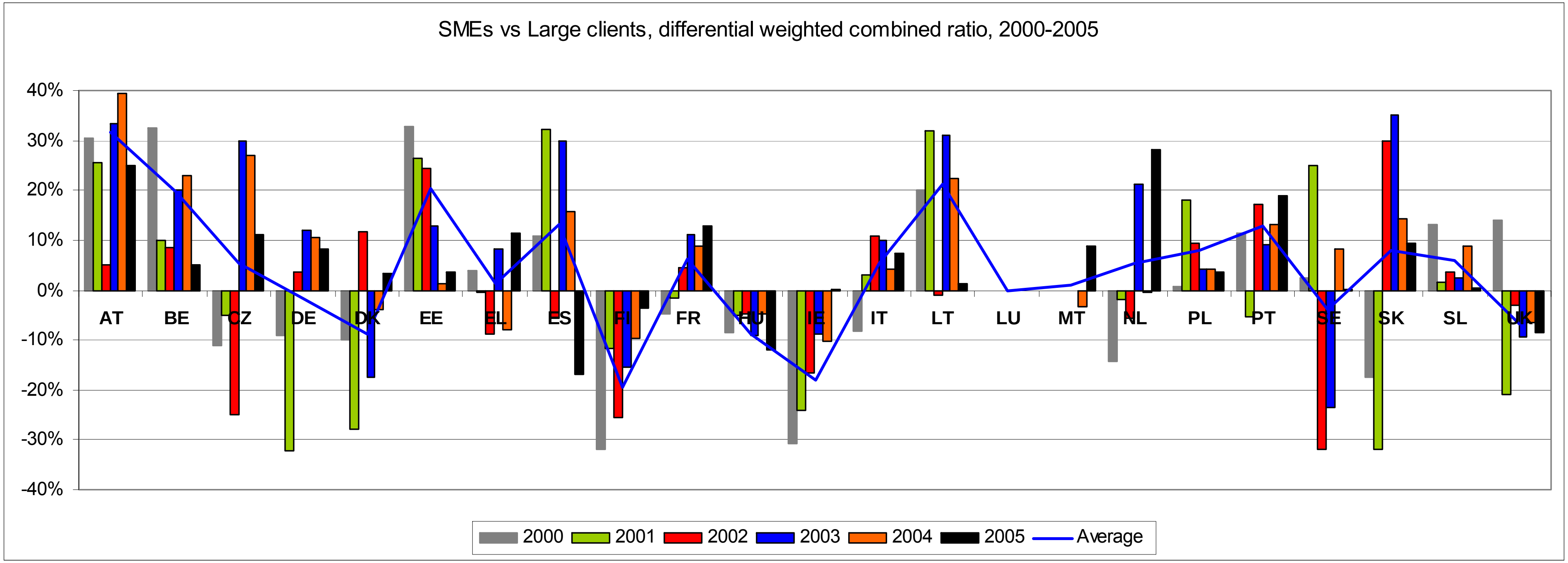
4. SMEs versus large clients

Respondents have provided financial data according to two types of costumers: SMEs and large clients. For the purpose of this enquiry, the definition of SME includes any company whose staff number is below 250 and whose turnover is under 50 MEUR (million EUR). Micro-companies are thus included in the SME category. It is therefore of interest to assess how the combined ratio, which encompasses all lines of business, varies across these two very different customer segments. It should be noted that, according to our survey, premiums from SMEs are significant part of the Insurers total premiums (60%).

This study aims to assess whether small costumers tend to get a less favourable deal in terms of combined ratio than larger clients. The following analysis may be subject to certain limitations, as it assesses solely the "size" parameter of a customer. Consequently, the very fact of different combined ratios of smaller clients versus larger clients may not represent a "discriminatory" treatment in itself, as our analysis does not take into account other client-specific characteristics, such as, for example, the more accurate risk rating alleged to apply to larger clients, which might distort the results to a (small) degree.

Figure VI.8 illustrates the difference between the weighted combined ratio of SMEs minus that of 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).

Figure VI.8 – Weighted combined ratio for SMEs and large Clients, country-level, 2000-2005



Source: European Commission, Business Insurance Survey 2005-2006

Several relevant facts can be drawn from the analysis of this figure. Firstly, it shows that the pattern of the combined ratio applied to SMEs and large companies varies significantly across the EU-25. Looking at 2005, for instance, it can be ascertained that while a number of Member States (Austria, Belgium, Lithuania, and Slovakia) have a clearly higher combined ratio for SMEs than for Large companies, in other Member States (Spain, Finland, Hungary and the UK), the combined ratio is significantly lower for SMEs than for Large companies.

Secondly, the pattern showing the difference between SMEs and large companies is relatively consistent over time in some Member States but quite divergent in others. The combined ratio of SMEs has been consistently higher than that of large companies in Austria, Belgium, France, Greece, Latvia, Portugal and Slovenia. In Finland, Ireland, and the UK, the ratio of SMEs has been always lower than that of large companies. The rest of the Member States display a highly diverging pattern. Germany, the Netherlands, Italy and Spain, for instance, combine periods in which the weighted combined ratio for SMEs is clearly higher than that of large companies with other periods where the difference between SMEs and large companies goes in the opposite direction.

Thirdly, and finally, Member States that display consistently lower combined ratios for SMEs over the entire period observe higher underwriting profitability in the segments of small clients as opposed to bigger ones. This might indicate a possible “discrimination” across client segments, which might be due to the lack of buyer power among SMEs. Moreover, this “discriminatory” aspect cannot be ruled out in cases where companies combine higher ratios for SMEs than large clients only in some years of the period.

5. 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 is high in business insurance at the EU-25 level and has also been sustained over time in most Member States. A comparison based on 2005 data, for instance, shows that on average the pre-tax profit in business insurance was around 26 % across the three largest European insurance markets.

The underwriting profitability varies significantly both in terms of business lines and Member States. Profit ratios vary up to 200 % across the EU-25 for the same insurance line and up to 100% within the same country for different insurance lines. For instance, the underwriting profit for each premium Euro is on average 64 cents for Environment Impairment Liability and only 5 cents for Motor in 2005. Also, Slovakian insurance companies have an underwriting profitability on business insurance that is 100% higher than that of the Danish insurers. 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.

The New Member States tend to have systematically higher underwriting profitability ratios than the EU-15. Lines tend display a lower combined ratio when the market is growing - clients "pre-pay" their insurance but claims are more likely to arise in the future -, which may be the case for the EU-10. However, the magnitude of the differential in the combined ratios of the EU-10 and the EU-15 suggests that other factors may also play a role in explanation of these differences.

There are also wide variations in insurers’ income for specific product lines within the same country. Taking Ireland as an illustration, results for 2005 show hat 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. We cannot therefore rule out that profit in different line of insurance might be used to subsidise losses in other lines, which would be unprofitable otherwise.

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%.

Interestingly, the New Member States tend to display consistently higher Expense ratios that the EU-15 throughout the period 2000-2005. Yet, as mentioned above, the New Member States display consistently higher combined ratios than the EU-15 for all lines. Reading these two findings together, it results that less efficient markets are also the most profitable ones in the EU. Moreover, it also shows that the cost base structure between these two groups of countries is significant and it is not converging, which might be a symptom of market fragmentation.

The size of these differentials seems to indicate an important degree of market fragmentation and the potential scale for price reduction in parts of the EU-25. High and sustained profitability in some Member States might be the result of the exercise of market power. In fact, while the need to reserve for future catastrophes and also the need to balance years of high losses across time is recognised, the magnitude of some figures suggest a need for further investigation. This further investigation will focus on a possible causality between financial performances and possible barriers to competition in some markets.

The pattern of the combined ratio applied to SMEs and large companies varies significantly across the EU-25. The Member States that display a consistently lower combined ratio for SMEs over the entire period seem to observe higher underwriting profitability in segments of small clients than bigger ones. 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. Moreover, this "discriminatory" aspect cannot be ruled out in cases where companies combine higher ratios for SMEs than large clients only in some years.

VII. DURATION OF CONTRACTS IN THE BUSINESS INSURANCE SECTOR

1. Introduction

Amongst the various data concerning business insurance products and product design collected from the insurance companies during the Sector Inquiry, the Commission decided to focus its 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 could raise. These concerns were also raised during the Sector Inquiry by some market participants.

2. The Findings of the Sector Inquiry

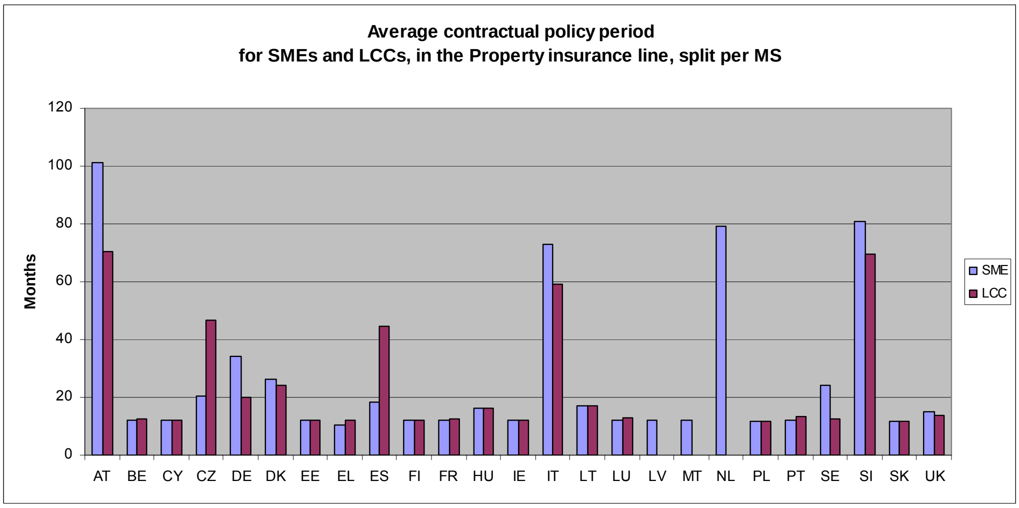
2.1. Duration of contracts

The data collected from the insurance companies during the Sector Inquiry confirms that the use of annual contracts is a common practice in a number of Member States. However, contracts of longer duration are still frequently used in a few Member States.

There appears to be no significant difference between the duration of business insurance contracts with LCCs and with SMEs.

Figure VII.1[68] below shows the average duration of contracts for LCCs and SMEs as far as the Property/Business Interruption insurance line is concerned.

Figure VII.1



Source: European Commission, Business Insurance Survey 2005-2006

As far as contracts for SMEs are concerned, in a majority of Member States (Belgium, Cyprus, Estonia, Greece, Finland, France, Ireland, Luxembourg, Latvia, Malta, Poland, Portugal and Slovakia), the average duration of contracts is approximately 12 months. In six further Member States (Czech Republic, Spain, Hungary, Lithuania, Sweden and the United Kingdom), the average duration does not exceed 24 months. In a few Member States, however, the average duration is much higher: approximately eight years (101 months) in Austria,

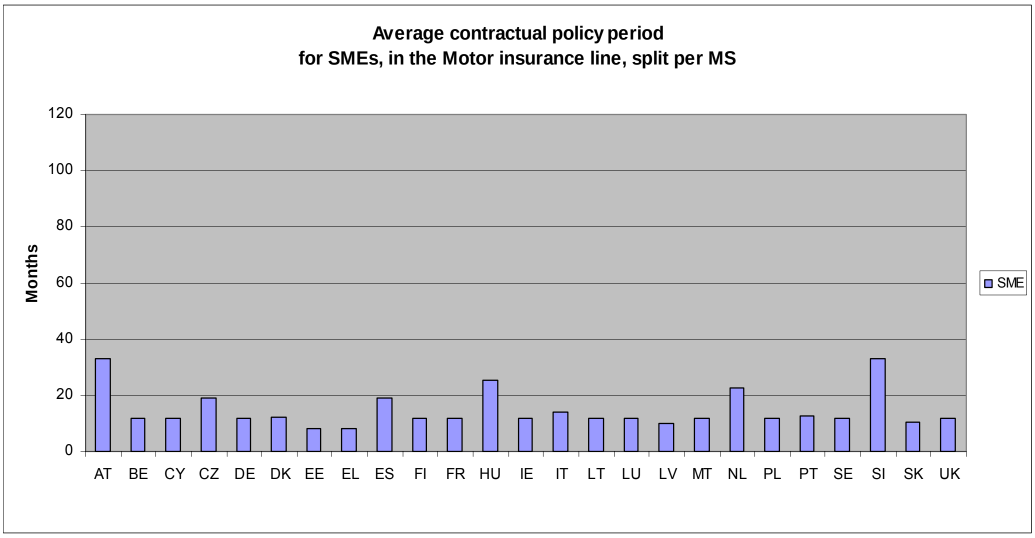
[68] This figure does not include data concerning the average duration of contracts for LCCs in Latvia, Malta, and the Netherlands as these data are of limited statistical relevance, due to the low number of observations related to this specific question.

almost seven years (81 months) in Slovenia and approximately six years in Italy and the Netherlands (respectively, 73 and 79 months).

A comparison of the data concerning business insurance contracts with SMEs with those concerning contracts with LCCs shows that in the Member States with a practice of annual contracts, the difference between the two types of business is not significant as far as contract duration is concerned. In the Czech Republic and Spain, the average duration increases respectively from 20 months (for SMEs) to 47 months (for LCCs) and from 18 (for SMEs) to 44 months (for LCCs). Conversely, in Sweden, the average contractual period goes down from two years to one. However the most significant reductions of the average contractual period in absolute terms can be witnessed in two of the countries showing the longest contractual period for SMEs: Austria and Italy. In Austria, the average duration goes down from 101 to 70 months (i.e., from approximately eight years to almost six years) and, in Italy, the average contractual period is reduced from 73 to 59 months. As far as Slovenia is concerned, the reduction is of the order of 10 months (from 80 to 70). The Commission does not have adequate data concerning LCCs in the Netherlands, the fourth country showing a peak in the average duration of insurance contracts for SMEs.

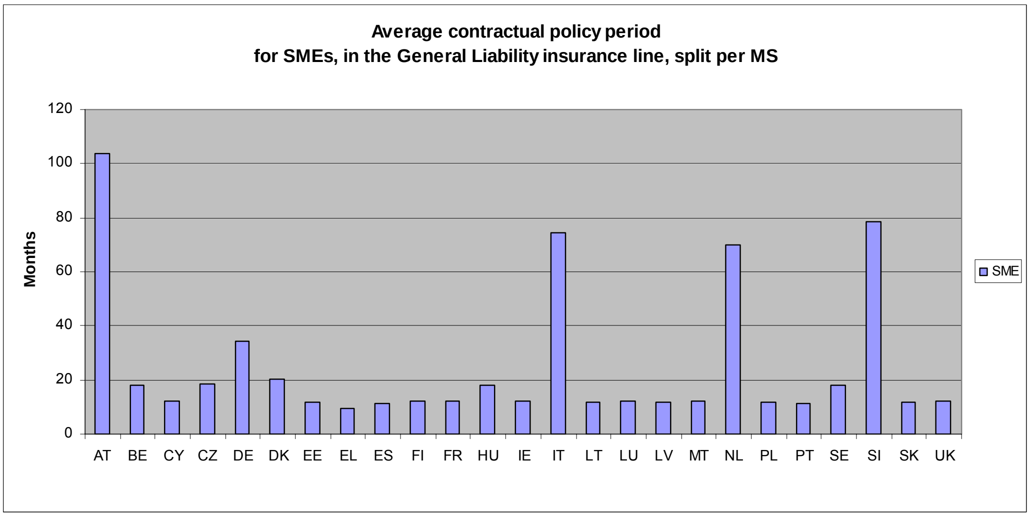
Figures VII.2 and VII.3 show the average duration of contracts for SMEs as far as the Motor and the General Liability insurance line are concerned.

Figure VII.2



Source: European Commission, Business Insurance Survey 2005-2006

Figure VII.3



Source: European Commission, Business Insurance Survey 2005-2006

The Motor insurance line presents the lowest average duration at EU level (14 months, compared to 28 for Property/Business interruption and 27 for General Liability). The peaks of duration do not exceed three years and, as for Property/Business Interruption, are recorded by Austria and Slovenia. The Netherlands show an average contract duration (22 months) higher than the EU average, but Italy has, in the case of Motor insurance, an average duration aligned with the EU average.

As for the General Liability insurance line, the variation of the average contractual period in the various Member States is very similar to the variation of the average contractual period measured for Property/Business Interruption, with very high peaks (between about six and eight years) for Austria, Italy, Slovenia and the Netherlands and an established practice of annual contracts in the majority of the Member States.

2.2. Renewal or extension of contracts

The Commission has also investigated contractual practices concerning the extension or renewal of the business insurance contracts.

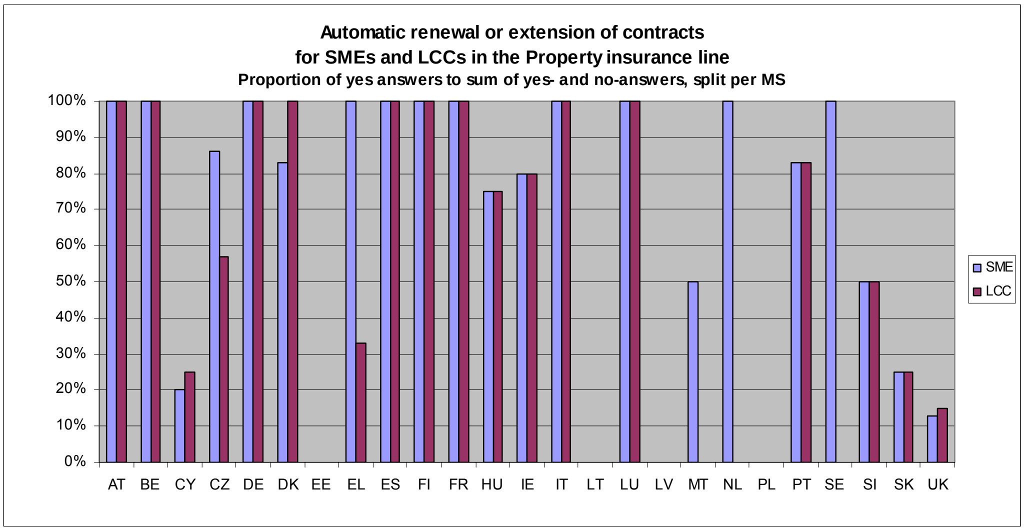
Figures VII.4[69], VII.5[70] and VII.6[71] below present the replies of the insurance companies to the question whether or not insurance contracts concerning SMEs as well as LCCs are extended or renewed automatically, if not cancelled by one of the parties.

[69] This figure does not include data concerning contracts for LCCs in Latvia, Malta, the Netherlands and Sweden as these data are of limited statistical relevance. This is due to the low number of observations related to this specific question.

[70] This figure does not include data concerning contracts for LCCs in the Czech Republic, Estonia, Greece, Hungary, Latvia, Malta, the Netherlands and Sweden as these data are of limited statistical relevance. This is due to the low number of observations related to this specific question.

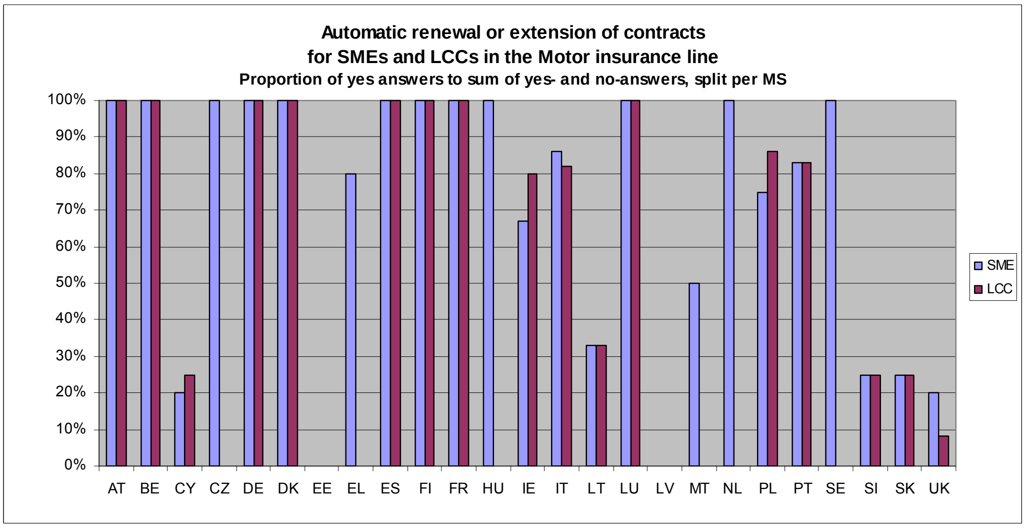
[71] This figure does not include data concerning contracts for LCCs in Estonia, Greece, Latvia, Malta, the Netherlands and Sweden as these data are of limited statistical relevance. This is due to the low number of observations related to this specific question.

Figure VII.4



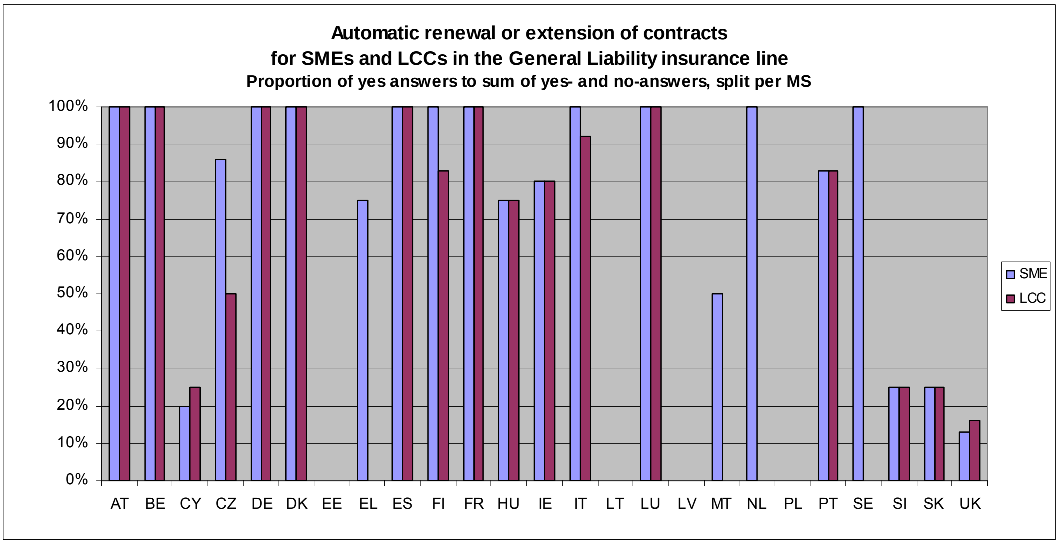
Source: European Commission, Business Insurance Survey 2005-2006

Figure VII.5



Source: European Commission, Business Insurance Survey 2005-2006

Figure VII.6



Source: European Commission, Business Insurance Survey 2005-2006

The percentage of insurers having made an affirmative reply to the question concerning the automatic extension or renewal is extremely high for all three insurance lines: the averages at the EU level are, for contracts with SMEs, 68 % for Property/Business Interruption, 74 % for Motor and 67 % for General Liability. The percentages for LCCs are very similar: 66 % for Property/Business Interruption, 74 % for Motor and 64 % for General Liability.

It appears that the practice of automatic renewal or extension is less frequent in Cyprus, Slovenia, Slovakia and the United Kingdom. In these Member States, the percentages of affirmative answers do not exceed 50 % and they very often reach only 25% or below for the three insurance lines in question and for the two categories of business insurance customers. Moreover, the practice seems *prima facie* non-existent (0 % of affirmative answers) in Estonia, in Lithuania (with the exception of a 33 % score for both SMEs and LCCs, in Motor), in Latvia (where data concerning LCCs are however not significant) and in Poland (with the exception of the Motor insurance line, where, conversely, the percentages are very high: 75 % for SMEs and 86 % for LCCs).

In all the other Member States, the percentages of insurers having made an affirmative reply to the question concerning the automatic extension or renewal are extremely high, scoring very often between 80 and 100 % and attaining 100 % for all three lines and for both categories of customers in Austria, Belgium, Germany, Denmark (with the exception of a 83 % score for SMEs in Property/Business Interruption), Spain, Finland (with the exception of a 83 % score for LCCs in General Liability), Luxembourg and both the Netherlands and Sweden (where data concerning LCCs are not significant).

3. Competition Analysis

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. As long as length is inherent to product definition, it seems doubtful that it could be seen as a restriction of competition[72].

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

However, if this is not the case, agreements of long duration (so-called long-term agreements)[73] 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[74]. 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.

This might happen when long-term agreements "combine with others to have a cumulative effect on competition"[75]. 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"[76] and, on the other, to the conditions under which competitive forces operate on the relevant market[77]. 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. Finally, 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[78].

In case 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 (Verticals Regulation)[79].

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73 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 seen above, are extremely frequent in the business insurance industry, and on the conditions for termination of such agreements by the business customer, whose utilisation is not illustrated by data of statistical relevance.

74 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) 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) 358/2003).

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

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

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

78 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)

79 Commission Regulation (EC) N° 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 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

4. Conclusions

The analysis developed above does not pretend to already identify the existence of restrictions to competition in a specific insurance market. It gives some indications on the issues that should be taken into account when assessing the competition concerns raised by long-term agreements in the business insurance sector. Further investigation will assess the likelihood of these risks of foreclosure.

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 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.

VIII. REINSURANCE

1. The rationale for reinsurance

The rationale for reinsurance is founded on a number of its key functions and benefits, which are briefly outlined below.

1.1 Catastrophe protection

The first specialist reinsurance companies were established in response to the growing size of loss exposures in the nineteenth century and the inability of individual (mainly fire) insurers to absorb the large losses that could result.

Reinsurance still fulfils this function and, in particular, enables very large loss exposures to be spread across international insurance markets in cases where local risk spreading (e.g. by means of coinsurance) would not be adequate.

1.2 Stabilisation of primary insurers and primary insurance markets

Loss patterns on the portfolios of primary insurers are subject to fluctuations over time. These fluctuations can be large as a consequence of the relatively small size of a portfolio, the presence within it of large individual risks, interdependence between exposure units that produces an accumulation of risk or simple fluctuations in the underlying probabilities of loss. Reinsurance programmes can reduce these fluctuations, producing a more balanced earnings curve and so reducing the primary insurers' capital costs. The risk of individual insurer insolvency is also reduced, which helps to stabilise the insurance market as a whole.

1.3 Increased capacity and flexibility

The availability of reinsurance (especially in treaty form) gives insurers additional underwriting capacity and enables them to take on risks which they would otherwise have to refuse, or which they could assume only by providing more capital of their own. The indirect capital provided by a reinsurer is likely to be cheaper for the primary insurer than equity capital, since reinsurers can assume risks at lower rates because of their superior diversification of risk. In this regard, the availability of reinsurance capacity is especially valuable for new and relatively small insurance companies, to support them in the early phases of their growth.

1.4 Advice and technical support

The large size of the major professional reinsurers, the wide scope of their activities and the international reach of their businesses has enabled them to gain a strategic view of world insurance markets and amass substantial experience, especially in relation to large, complex and unusual coverages and risks with an international dimension. Hence, many primary insurers, especially relatively small firms and those in emerging markets, rely on the major reinsurance groups for technical support, including advice in fixing rates and determining appropriate terms and conditions of coverage.

2. The demand for reinsurance

The demand for reinsurance on the part of a given insurer, and for a national insurance market as a whole is determined by a number of factors.

2.1 Lines of insurance written and nature of the portfolio

As suggested above, the size of a primary insurance portfolio and characteristics of risks within are key factors in determining the need for reinsurance. Thus, a relatively large primary insurance portfolio comprising mainly small risks will, as a consequence of the law of large numbers, be much more stable than a relatively small portfolio comprising mainly large risks.

The need for reinsurance is also inherently greater for some lines of insurance business. For example, aviation and space risk portfolios are heavily reinsured, because not only are individual aircraft values and associated liability exposures high, but the chance of a total loss (as against a partial loss) of an aircraft or space vehicle is much higher than other in most other classes. Conversely, the need for reinsurance is much lower for motor insurers, because individual values of motor vehicles are very much smaller on average and there is less chance of a catastrophic loss. Furthermore, aviation portfolios are likely to contain fewer exposure units than motor portfolios because, worldwide, the number of motor vehicles requiring insurance vastly exceeds the number of aircraft in operation.

Finally, the extent to which reinsurance is required may also depend on the geographical location of the risks concerned. If risks are concentrated in an area that is exposed to potentially catastrophic perils such as flood, windstorm or earthquake, there will be a greater need for reinsurance to guard against a major accumulation of losses arising from one extreme event.

2.2 Characteristics of individual insurers and markets

As noted earlier, the size of an individual insurer in terms of its available capital will heavily influence its need for reinsurance, with large well-capitalised insurers being able to write bigger exposures and retain more risk for their own account.

By extension, the need for reinsurance at national level will depend on the lines of insurance customarily written in the particular market, its size and the typical characteristics of insurers operating within it. Thus, a large market with a high degree of concentration (and, hence, large insurers) will generate less demand for reinsurance than a small market with a low degree of concentration. Again, the extent to which a country as a whole is exposed to natural catastrophic perils of the sort described above will influence the reinsurance needs of its primary insurers.

3. The significance of reinsurance in the EU insurance market

It is not wholly appropriate to talk of reinsurance in the context of a single geographical/political area such as the EU, because reinsurance is essentially an international business. Certainly, the first reinsurance companies were established to increase capacity and achieve a better spread of risk within national insurance markets but reinsurance soon took on an international role, effectively fulfilling the need to spread very large potential risk exposures across international markets so as to exploit the benefits of the law of large numbers.

However, major reinsurers established in the EU play a large role in reinsuring business around the world. Table VIII.1 shows the allocation of global reinsurance premiums by country of domicile of the recipient reinsurance companies. The figures include life reinsurance as well as non-life, but only about 20% of reinsurance premiums come from the non-life source.

Table VIII.1: Global reinsurance premium by country of reinsurer domicile

Domicile	Proportion of global reinsurance premium 2005 (EUR 120 bn.)
US	24%
Germany	23%
Bermuda	11%
Switzerland	10%
UK	7%
Japan	7%
France	4%
Ireland	2%
Rest of the world	12%

Source: Standard and Poor's Global Reinsurance Highlights 2006

We can also note that while the US, the world's biggest non-life insurance market, accounts for 43% of direct non-life premiums, against around 7.4% for Germany (which ranks second), US domiciled reinsurance companies accounted for 24% of global reinsurance premium in 2005, compared to 23% for Germany[80].

4. Reinsurance volumes and retention ratios

The International Association of Insurance Supervisors (IAIS) provide the figures in table VIII.2 for reinsurance volumes, in terms of premiums ceded by primary insurers to unaffiliated reinsurers, based on data from Swiss Re[81].

Table VIII.2: Gross premiums and premiums ceded by primary insurers (EUR bn) *

Non-life	1990	1995	2000	2001	2002	2003	2004
Gross premiums	422.0	569.6	820.9	908.9	980.4	955.0	954.4
Ceded premiums	47.0	68.7	102.3	120.7	131.8	124.7	108.0

Source: IAIS (2005) Global Reinsurance Market Report 2004

* Sums converted from US dollars with 1995 and 1990 figures based on US dollar/ECU exchange rate

We can note that out of a total non-life insurance income of EUR 954.4 bn just under EUR 108 bn was ceded to reinsurers in 2004, so reinsurance premiums amounted to around 11.3% of total direct non-life premiums. The figures above refer to 'open market' reinsurance and do not include reinsurance premiums ceded to affiliated companies, such as the internal reinsurance cessions carried out within large primary insurance groups as a diversification measure. Finally, we should bear in mind that non-life insurance includes personal lines such as home, travel and private car insurance, as well as business insurance. Broadly speaking, personal lines portfolios (and motor insurance generally) requires less reinsurance than books of business insurance, so the portion of premium ceded to reinsurers will be higher than the overall average in the case of the latter. For large corporate clients as opposed to SME businesses it will be higher still, because large industrial and commercial risks are reinsured more heavily.

80 Percentages for insurance premium volumes were derived from Swiss Re, *sigma* No. 5/2006, p. 35.

81 The data do not cover the whole world but 50 jurisdictions. See IAIS' Global Reinsurance Market Report 2004, pp. 29-30.

As a comparison to this 11.3% figure, we found an average cession rate of 18% in our sample for business insurance and for EU-25 but, in our case, internal reinsurance was included.

5. The Supply of Reinsurance

5.1 Sellers of reinsurance

We noted in Chapter III that reinsurance is written by professional (specialist) reinsurers, direct insurance companies that also write reinsurance, and by Lloyd's syndicates. We also noted that some reinsurers themselves buy cover for the risks they have assumed, a process known as retrocession, which is especially common in the London insurance market.

According to Swiss Re, around 60% of direct non-life insurance premiums ceded in 2001 went to 18 large reinsurance groups, equivalent to 8% of direct insurance non-life premiums. The remaining 40% went to primary insurers writing inwards reinsurance and to smaller professional reinsurers. They also note that in 2001 around 21% of non-life reinsurance premium was retroceded.[82]

5.2 Reinsurers in the EU

As we have seen already, the major providers of reinsurance in the EU are located in the largest Member States, and most notably in Germany, the domicile of the major reinsurers Munich Re, Hannover Re and Allianz Re and many smaller firms. The UK and France are also significant domiciles for reinsurers. By contrast, in both absolute and relative terms, little reinsurance is written in the medium-sized and smaller EU Member States and less still in emerging EU insurance markets.

6. Reinsurance market trends

There was a substantial expansion in the number of professional reinsurers during the 1960s, but events in the mid 1980s and early 1990s triggered dramatic change.[83] In particular, the US liability insurance crisis of the mid 1980s[84] and the accumulation of natural catastrophe losses of the early 1990s[85] created serious solvency problems for a number of reinsurers, including Lloyd's.

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[82] Swiss Re, *sigma* No. 5/2003, p. 11. Retrocession poses the risk of a 'spiral' being created in which insurers underwrite again part of the very risks that they have ceded. This happened in the case of the notorious London Market Excess (LMX) 'Spiral' of the early 1990s when a number of Lloyd's syndicates continuously retroceded, on commission, a large part of their business with the effect that they often underwrote their retroceded risks again, sometimes without being aware of it. Once multiple commissions had been deducted there was insufficient capital left to pay claims, aggravating the crisis at Lloyd's.

[83] See Swiss Re, *sigma* No 9/1998, p. 11, for a full account.

[84] This refers to an upheaval in the United States liability insurance market in the mid-1980s when property/casualty insurers made huge losses – around EUR 4.8 bn in 1984 and EUR 7.2 bn in 1985 – such that insurer insolvencies became commonplace. In most years reinsurers made even greater losses than direct insurers and poor experience in North America in particular affected reinsurance markets throughout the world. Reinsurers in Europe and North America reduced their lines, increased rates and imposed restrictive conditions. Cover for North American risks was severely restricted. Direct insurers were obliged to follow suit and liability insurance capacity dwindled alarmingly with cover for some high-risk activities becoming virtually unobtainable. See, for Priest, G. 'The Current Insurance Crisis and Modern Tort Law' 96 *Yale Law Journal* (1987) for a good account.

[85] There were 16 such 'catastrophes' during a time period when four would have been a more normal expectation. They included winter storms in Europe (1990), Typhoon Mireille in Japan (1991) and, especially, Hurricane Andrew (1992) in the USA. Besides these natural events they included the 1988 *Piper Alpha* oil rig explosion and fire.

Following Hurricane Andrew in 1992 the number of active reinsurers fell as many went bankrupt or withdrew from the market. This had two main consequences. First, the industry responded by setting up eight catastrophe (CAT) insurance companies in Bermuda with the assistance of capital from outside the insurance market. These helped to fill the gap in capacity which Lloyd's and existing insurers struggled to fill. Within four years they had acquired 5% of the world reinsurance market, a figure which has subsequently risen to 11%. In response to falling reinsurance prices they then diversified into other lines of insurance and consolidated, so that few of these original companies remain.

The second consequence has been described as a 'flight to quality' whereby insurance companies tended to shun reinsurance providers with small capital resources and turned to the large professional reinsurers. This, in turn, led to a phase of consolidation in which a large portion of the reinsurance market changed hands.

In 1990 the top four reinsurance groups had just 22% of the world reinsurance market and the top 10 around 34%. By 2005 the share of the top four had risen to around 42% and that of the 10 to around 62% (see Table VIII.3). Recently, concentration has increased further as a consequence of Swiss Re (previously the second largest global reinsurer) successfully acquiring GE Insurance Solutions (previously number 5) to become the largest reinsurance group.

Table VIII.3: Concentration in world reinsurance markets 1990 – 2005 (life+non-life)

Year	Top 4 share	Top 10 share
1990	22%	34%
1994	25%	40%
1998	32%	51%
2005	42%	62%

Source: Swiss Re, Standard & Poor's Global Reinsurance Highlights 2006

7. Reinsurer security and choice of reinsurers

In this section we consider the linked issues of reinsurer security and the factors that inform the decisions of primary insurers in arranging their reinsurance protection.

7.1 Reinsurer security

Reinsurer security has become a prominent issue in recent years, not least because of the massive shocks delivered to insurance markets as a consequence of major events such as Hurricane Andrew, 9/11 and more recently, Hurricane Katrina.[86] Concern has been raised as to the resilience of the reinsurance sector in its ability to absorb such losses. This concern has extended beyond the primary insurance industry (for which reinsurer security is a natural

[86] It is worth noting that the impact of Hurricane Katrina has been much less dramatic than Hurricane Andrew, the key loss event of the 1990s. The cost of Katrina to the reinsurance industry is likely to be much higher than Andrew: the latter led to insured losses of around EUR 16 billion, 30% of which were ceded to the reinsurance markets, whereas insured losses from Katrina are likely to be around EUR 39 billion, around 50% of which will fall to the reinsurance markets. However, the Katrina losses are not expected to lead to problems of solvency. Fitch note that they occurred following 'a sustained period of technically adequate premium rates and strong capital formation' (FitchRatings, 'Midyear 2005 global reinsurance review and outlook', September 2005.) Nevertheless, Katrina has highlighted the limitations of the catastrophe models used by insurers to monitor aggregate geographic exposures, even though these have improved significantly since Hurricane Andrew prompted greater research in the field. The point here is that insurers had underestimated the extent of losses that could flow from the impact of such a hurricane on New Orleans.

concern) to a number of international bodies, and notably the Financial Stability Forum (FSF) founded in 1999 by the G7 finance ministers and heads of central banks to help support the stability of the international financial system. The FSF, along with others, perceived the possibility of systemic risk arising through reinsurance and expressed concern on a number of grounds including:

- the possibly harmful effects on business of a withdrawal of reinsurance cover;
- the knock-on effects of reinsurer bankruptcy on primary insurance markets;
- the complexity and inadequate representation in (re)insurers' accounts of financial reinsurance;
- the possibility of retrocession spirals;
- the effect of reinsurer failure on counterparties in the non-insurance sector, in particular contagion via reinsurers' participation in the market for credit derivatives;
- the lack of internationally uniform sets of accounting standards making uniform assessment of reinsurers impossible;
- the inadequacy of the assessments of rating agencies as a wholly reliable indicator of potential reinsurer failure.

Reinsurance security is also viewed as an important issue by insurance regulators. This is illustrated by the supervisory standards touching on reinsurance which the International Association of Insurance Supervisors (IAIS) has agreed in recent years. They include:

- Supervisory Standard on the Evaluation of the Reinsurance Cover of Primary Insurers and the Security of their Reinsurers (2002)
- Standard on Supervision of Reinsurers (2003)
- Standard on Disclosure Concerning Technical Performance and Risks for Non-Life Insurers and Reinsurers (2004)

Amongst many other things, the 2002 Standard states that every insurer should have a clear reinsurance strategy agreed at Board level, maintain an up-to-date list of reinsurers that it has approved, and may improve security overall by using a number of reinsurers. It also observes:

'Generally speaking, if no requirements are placed on the choice of reinsurer or on the posting of collateral, the fewer the number of reinsurers used, the more an insurer should pay importance to the security of its reinsurers. If a company takes advice on the strength and security of a reinsurer, then it should satisfy itself that the advice is sound. Similarly, if reinsurance cover is acquired through an intermediary, the company should evaluate the operational risk associated with the transaction.' (Paragraph 15).

The 2004 Standard goes on to stipulate the information that insurers should disclose to regulators, including detailed information concerning the adequacy of their reinsurance arrangements, how reinsurance is obtained, information on their reinsurers and on the credit risk involved. Insurers are expected to disclose the total amount of reinsurance assets included in the balance sheet and provide further quantitative information, including information as to the credit quality of the reinsurers chosen, the proportion of reinsurers that are supervised and the nature and amount of collateral held against reinsurance assets.

7.2 Choice of reinsurers

In this section we consider the factors that inform the decision of primary insurers in their choice of reinsurers, both in terms of diversification and identity.

7.2.1 Diversification of reinsurance programmes

Reinsurance programmes are often complex and highly individual in their nature, depending on the reinsurance strategy of the primary insurers concerned.[87] Reinsurance is often arranged in layers, with several reinsurers participating in each layer. Again, different types of reinsurance are often combined within the same programme, but organised so as to respond sequentially. For example, there may be a combination of proportional reinsurance (e.g. a surplus share treaty or treaties) backed up by non proportional reinsurance (e.g. excess of loss) with the latter responding in cases where the net retained losses of the primary insurer exceeds a certain threshold once recoveries from the proportional part of the reinsurance programme have been taken into account.

Because reinsurance programmes are often complex it may not be possible to say *ex ante* what percentage of any given risk, or of the whole portfolio, is carried by the reinsurers either individually or collectively. However, it should always be possible to count the number of reinsurers involved in a given programme and also to estimate how total ceded premiums divide between the participating reinsurers.

There is very little published data on this subject, but a spot check carried out by Swiss Re of its non-life treaty reinsurance business in Europe revealed that only 10% of ceded premiums came from companies that entrusted more than 50% of their cessions to the company. The majority of customers ceded less than 30% of their portfolio to Swiss Re, suggesting a reasonable degree of diversification in the construction of its clients' non-life reinsurance programmes.[88]

In our questionnaire's sample, 40% of respondents said that there was a maximum percentage of their insurance premium that they would cede to the same reinsurer and on (not weighted) average this percentage was 35%. On a scale from 0 to 10, the importance of diversification of reinsurance obtains on (non-weighted) average a score of 7.2, which we can consider as being very high. This stresses again the importance to insurers of the diversification of their reinsurance program.

7.2.2 The influence of financial strength ratings and of the rating agencies on reinsurance

It is well understood that the rating agencies have a prominent role – indeed several prominent roles – in the operation of the reinsurance market. First, ratings from rating agencies are taken into account by buyers of reinsurance (including the intermediaries that advise them) as a guide to the security, and hence claims-paying ability, of the reinsurers that are selected to provide cover. Second, regulators are increasingly incorporating ratings into their rules. Third, ratings also play a key role in the contracts that reinsurers enter into through what are known as 'ratings triggers' (for example a cancellation clause if the reinsurers' rating is downgraded below a certain limit).[89]

The rating agencies provide two sorts of rating. The first, a financial strength rating (FSR) relates to a reinsurer as a whole and provides an indication of the reinsurers general

[87] A fact acknowledged by the IAIS: see the Standard on Disclosure Concerning Technical Performance and Risks for Non-Life Insurers and Reinsurers (2004), paragraph 43.

[88] Swiss Re, *sigma* No. 5/2003, pp. 25-26.

[89] See Swiss Re, *sigma* No. 4/2003 p. 25 for an account.

ability to honour claims and other financial obligations. The second, a debt rating, measures a reinsurer's credit worthiness in relation to a specific debt issue, which is relevant only in the case of reinsurers that have issued publicly traded debt. We will focus on the first sort of rating (FSR).

7.2.2.1 The principal rating agencies

There are well over 100 rating firms world-wide, but four large firms are especially prominent in the insurance sector. They are A.M. Best, Fitch Ratings, Moody's Investors Services and Standard and Poor's (S&P). Moody's and S&P are the largest firms and the latter is believed to be most prominent in the European insurance sector. A.M. Best focuses exclusively on the insurance sector, while the other firms do not.

Two sorts of financial strength rating are provided by the major firms. First, there are *interactive ratings* which are undertaken only with the full co-operation of the reinsurer's management. This results in a detailed review involving interviews with the firm's management, access to information that is not in the public domain and a thorough investigation into the firm's business. These ratings are then subject to continuous monitoring. Interactive ratings are funded by fees paid by the firm that is rated. By contrast, *involuntary ratings* are based purely on information in the public domain, including the firm's published accounts. They are not subject to continuous review and are usually reviewed on an annual basis. Evidence suggests that the overwhelming majority of reinsurers, including all the major firms, hold a rating from at least one agency and that a significant number have multiple ratings.[90]

The rating scales used by rating agencies do not conform to a uniform pattern. The scales and associated descriptive terms used by Fitch and S&P are very similar, but those of A. M. Best and Moody's differ rather more, as shown in table VIII.4.

[90] In a survey carried out by Bramall in 2001, 17% of respondents held no financial strength rating and 38% held three or more ratings (Bramall, S (2004) 'Do financial strength ratings have a positive or negative effect on the reinsurance industry?' Journal of Insurance Research and Practice Vol. 19 Part 2). Of the 150 reinsurers listed in S&P's 'Top 150 Reinsurers' published in 2006, around 19% appear not to hold an S&P rating.

Table VIII.4: Rating scales of the major rating agencies

A.M. Best		Fitch		Moody's		S&P	
SECURE		**SECURE**		**STRONG**		**SECURE**	
A++,A+	Superior	AAA	Exceptionally strong	Aaa	Exceptional	AAA	Extremely strong
A,A-	Excellent	AA	Very strong	Aa	Excellent	AA	Very strong
B++,B+	Very good	A	Strong	A	Good	A	Strong
		BBB	Good	Baa	Adequate	BBB	Good
VULNERABLE		**VULNERABLE**		**WEAK**		**VULNERABLE**	
B,B-	Fair	BB	Moderately weak	Ba	Questionable	BB	Marginal
C++,C+	Marginal	B	Weak	B	Poor	B	Weak
C,C-	Weak	CCC,CC,C	Very weak	Caa	Very poor	CCC	Very weak
D	Poor	DDD,DD,D	Distressed	Ca	Extremely poor	CC	Extremely weak
E	Under regulatory supervisions			C	Lowest	R	Regulatory action
F	In liquidation						
S	Rating suspended						
Within-category modifiers		+,-		1,2,3 (1 high, 3 low)		+,-	

Source: Swiss Re, sigma 4/2003, p.13

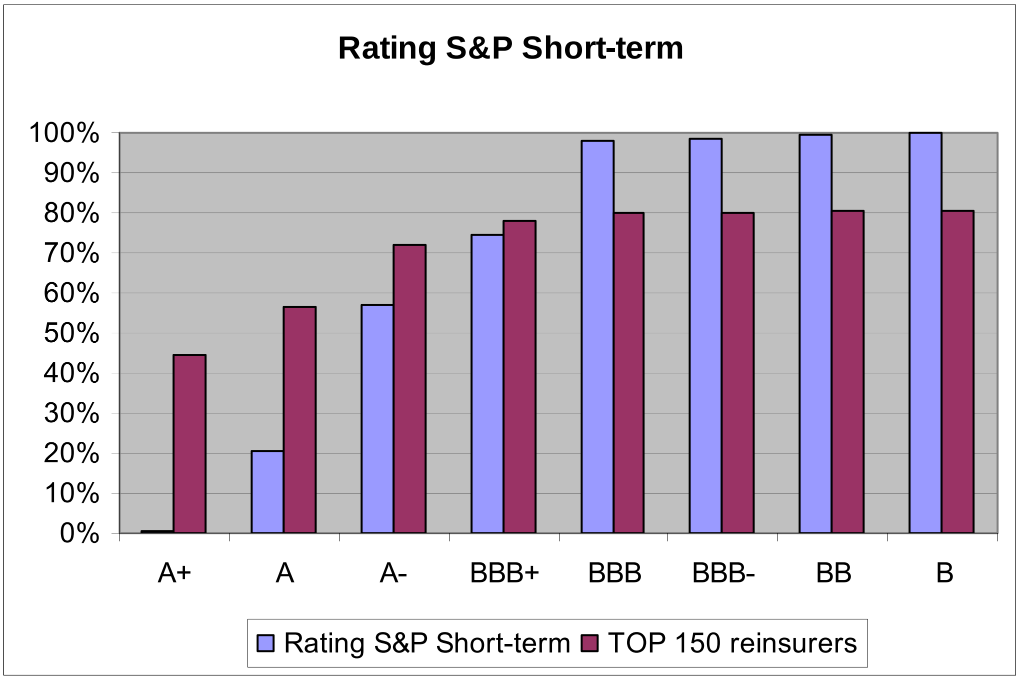
7.2.2.2 The use and impact of minimum ratings

The European Commission's practice in the field of merger assessment has considered that the provision of reinsurance should be regarded as a single relevant product market covering the provision of reinsurance for all classes of risk, as a reinsurer covering risks of a particular class may readily and quickly switch capital and resources from that class of cover to a different class of cover (supply-side substitutability). However, in our survey, 91% of insurers declared taking into account ratings when selecting reinsurers. Of these, 95% declared having defined a minimum rating below which they would not consider buying reinsurance from any reinsurer. This raises the question of the demand-side substitutability of the different reinsurers depending on their ratings and the expectations of the insurers.

To illustrate our point, one can look at figures VIII.1, VIII.2, VIII.3 and VIII.4 which show, for two rating agencies (S&P and A.M. Best), and for each rating, the percentage of insurers in our sample that would not buy reinsurance from a reinsurer holding a lower rating. The figures relate to both short-term and long-term business.

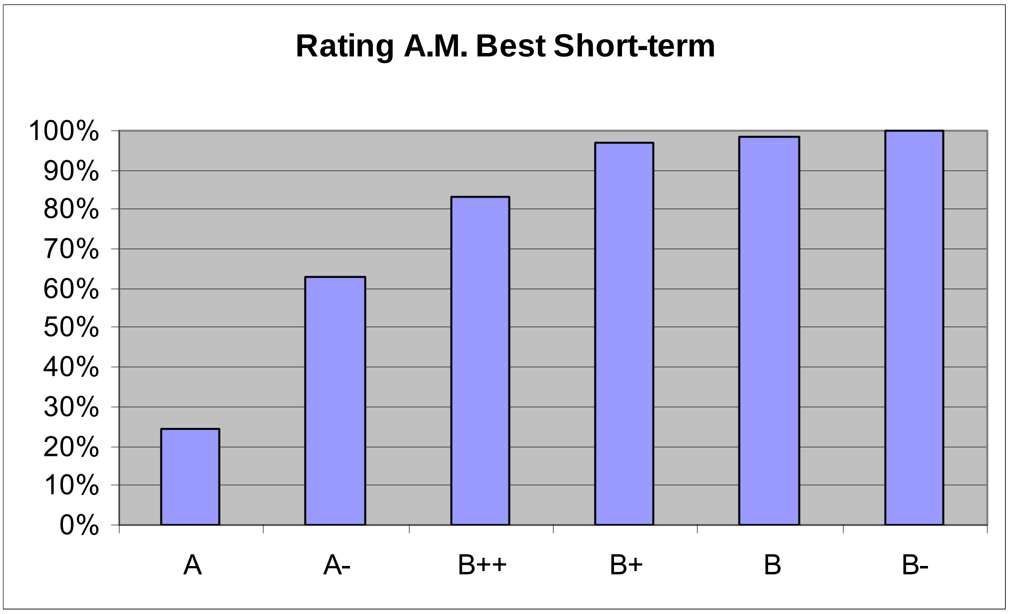
For S&P figures, we have added columns to indicate how many reinsurers from "the S&P Top 150 reinsurers" hold at least this rating. Only 81% of these reinsurers hold a rating from S&P so the maximum percentage is 81% and not 100%.

Figure VIII.1: Rating S&P Short-term



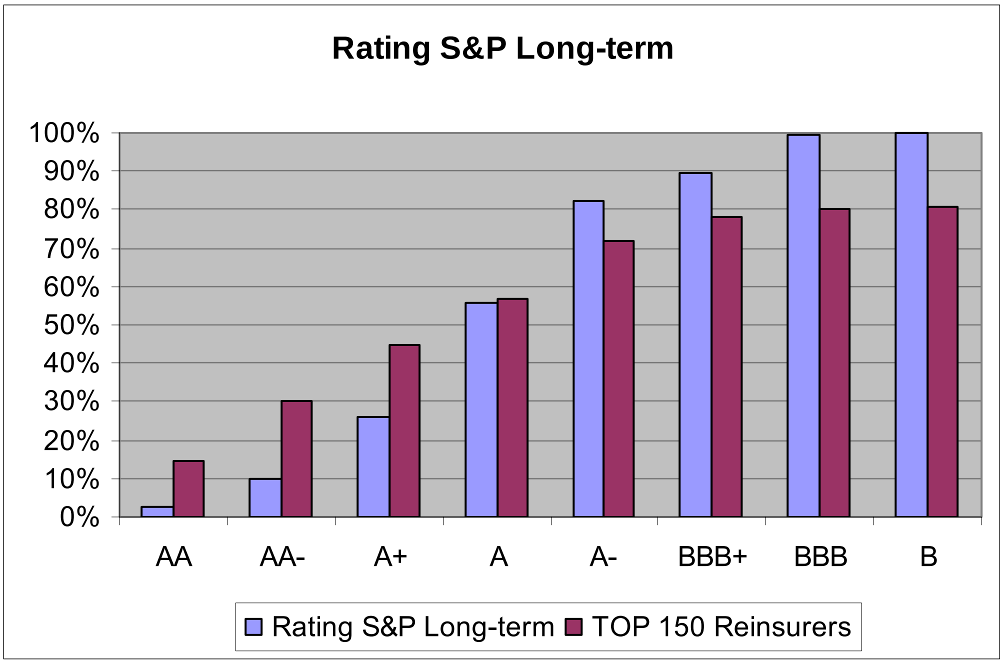
Source: European Commission, Business Insurance Survey 2005-2006

Figure VIII.2: Rating A.M. Best Short-term



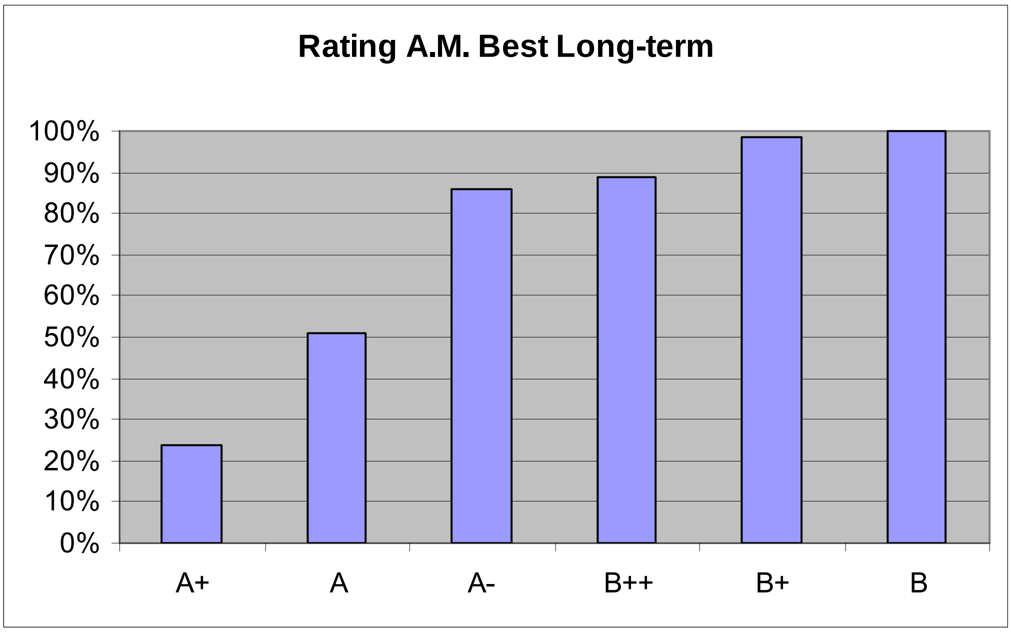
Source: European Commission, Business Insurance Survey 2005-2006

Figure VIII.3: Rating S&P Long-term



Source: European Commission, Business Insurance Survey 2005-2006

Figure VIII.4: Rating A.M. Best Long-term



Source: European Commission, Business Insurance Survey 2005-2006

The major rating agencies make a broad distinction between insurers that are 'secure' (or 'strong' in the case of Moody's) and those that are vulnerable (or 'weak' in the case of Moody's). This descriptive break point occurs below the level of BBB for S&P and below B+ in the case of A. M. Best. However, our evidence suggests that the breaking point – the point at which a sudden erosion of business volume is likely to occur as a consequence of a rating downgrading – is at a higher level:

- Among insurers using A.M. Best ratings, we can see that 83% would not consider buying reinsurance from a reinsurer holding a rating under B++ for short-term business and 86% under A- for long-term business.
- Among insurers using S&P ratings, 74% would not consider buying reinsurance from a reinsurer holding a rating under BBB+ for short-term business and 83% would not consider buying reinsurance from a reinsurer holding a rating under A- for long-term business.

We can consider all these respective ratings as being the breaking points.

We can also see that 56% of insurers using S&P ratings (which corresponds to 42% of our total insurers sample) would not consider buying reinsurance from a reinsurer holding a rating under A for long-term business. However, only 57% of the 150 biggest reinsurers hold such a rating (but one still has to take into account that 19% of these reinsurers do not hold an S&P rating but may be rated by another rating agency at a level that is sufficient for insurers).

Overall, this evidence implies that there might be some limits to the demand-side substitutability of reinsurers.

Furthermore, in the case of a decrease in the ratings of a considerable number of reinsurers, the question arises whether the insurers would maintain their ratings expectations, since this would lead to a situation where only a limited number of reinsurers would be able to provide cover to most insurers.

8. Distribution channels for reinsurance

Reinsurance is generally arranged either by direct dealing between the ceding insurer and reinsurer or through a reinsurance broker. The rationale for employing a broker in a reinsurance transaction is, in theory, much the same as that discussed in Chapter III in relation to ‘direct’ insurance broking: that is, a rationale based on (1) reducing search costs, (2) reducing the uncertainty created by asymmetric information between buyer an seller and (3) rectifying the asymmetric bargaining powers that may exist when small and medium-sized buyers of reinsurance deal with large reinsurance providers. However, since primary insurers are generally knowledgeable in relation to reinsurance (2) may be of little importance in reinsurance transactions and (3) will be relevant only in instances where the cedant insurer is a small firm and the reinsurer a large one. For these reasons direct dealing between primary insurers and reinsurers is quite common, many firms preferring the simplicity and clarity of a direct close relationship. The support that many reinsurers provide to their cedants in underwriting, claims and actuarial and other services implies a high level of direct contact. On the other hand, the extensive global contacts of reinsurance brokers can be considered valuable when a substantial amount of reinsurance cover is needed quickly or cover is required for a new, unusual or extra-hazardous risk, or one that requires the primary insurer to draw on reinsurance capacity on a global scale. The services of a broker are likely to be more in demand in relation to non-proportional reinsurance (e.g. excess of loss), because in this case the price of the reinsurance cover needs to be negotiated whereas, in the case of proportional reinsurance, premiums usually follow the original insurance premium rates, leaving less room for individual bargaining.

Table VIII.5 shows the major reinsurance brokers in the world.

Table VIII.5: Top ten global reinsurance brokers by reinsurance revenues (life + non-life), 2005

Rank	Company	Reinsurance revenues EUR mn	Country
1	Aon Re Global	739,5	USA
2	Guy Carpenter & Co Inc	673,6	USA
3	Benfield Group Ltd	474,1	UK
4	Willis Re	454,1	UK
5	Jardine Lloyd Thompson Group P.L.C.	125,3	UK
6	Towers Perrin	123,2	USA
7	Cooper Gay (Holdings) Ltd	74,6	UK
8	BMS Group	60,5	UK
9	Gallagher Re	60,3	UK
10	John B. Collins Associates Inc.	41,8	USA

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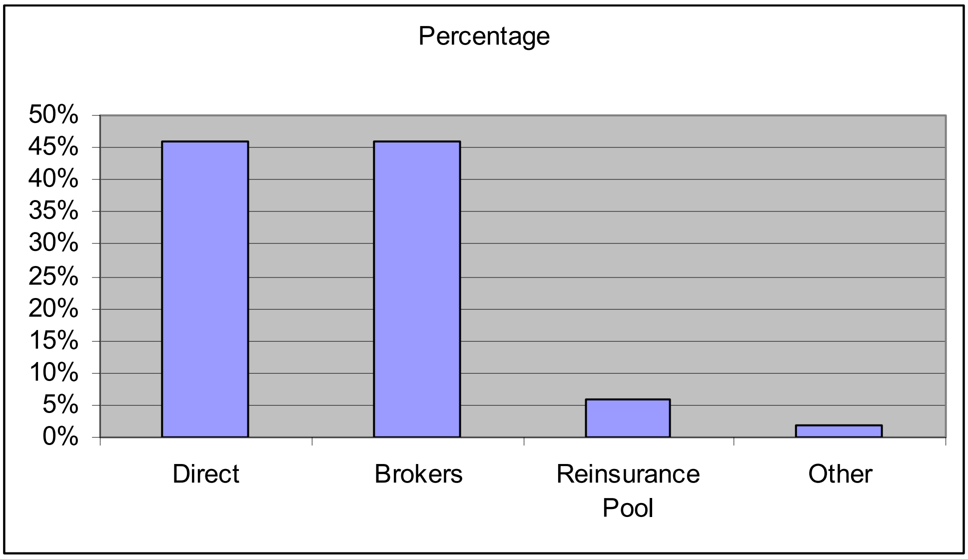
We can see that some major reinsurance brokers also have a strong presence in the (direct) insurance broking sector.

In order to assess the importance of the different distribution channels, we asked insurers what percentage of external reinsurance (non intra-group) they bought from each distribution channel (relating to non-life business insurance). To calculate average value per distribution channel for EU-25, we weighted the percentages by the amounts of reinsurance purchased[91]. Figure VIII.5 summarizes the results:

Figure VIII.5: Importance of distribution channels in terms of premiums sold



Source: European Commission, Business Insurance Survey 2005-2006

The amount of reinsurance arranged directly is around the same value as the amount arranged through brokers. The other distribution channels are not significant.

9. "Best Terms and Conditions" Clause

At different stages in the negotiation of a reinsurance contract, certain reinsurance companies insert a clause to the effect of benefiting from the best terms available to the

91 These amounts also contain internal reinsurance activity, which may limit the accuracy of the result.

participating reinsurers on this contract, without quoting these terms. Our inquiry shows that this clause can appear in treaty as well as in facultative reinsurance[92]. It can be written directly on the contract or appear through the stamp of the reinsurer. It can be imposed by one or several of the participating reinsurers.

The clause appears in many different ways. It can be a short text like:

- "Subject to best terms and conditions"
- "Subject to most favoured reinsurer terms and conditions"
- "Warranted no better terms carried".

But it can also appear along the following extensive lines:

"With the exception of respective percentages of participation, the Reinsured shall offer equal and identical terms, conditions and provisions within the context of this agreement <u>and any parallel reinsurance agreements</u> to any and all participating Reinsurers. In the event any such participating Reinsurer is offered terms more favourable than the terms herein <u>or in any parallel Reinsurance agreement</u>, this and <u>any parallel</u> agreements at the option of the disadvantaged Reinsurer shall be construed as containing terms identical to those offered to the favoured Reinsurer and shall be effective on the same date they were granted to the favoured Reinsurer." (emphasis added)

This clause looks like an "English clause", in other words a clause whereby a buyer, if he obtains from a competitor of its exclusive supplier a better offer, can ask its exclusive supplier to align himself to the better offer. However, while the "English clause" allows an alignment of prices at the advantage of the buyer, the "best terms and conditions" clause imposed by the reinsurers aims at harmonising terms and conditions at the highest level to the benefit of the reinsurers imposing it and to the detriment of the reinsured.

Original differences in reinsurance terms (construed as premiums and commissions) may, for instance, result from differences in solvency strengths and ratings of reinsurers or from differences in reinsurers' underwriting policy. They are also closely linked to a particular reinsurer's skills and experience and its assessment of the risk or portfolio of risks to reinsure.

By lifting the impact of these differences on the final premium paid by the reinsured, this type of clause contributes to maintaining higher premiums in the market than under fully competitive conditions.

Moreover, this type of clause increases price transparency and can, under certain market conditions, amount to a restriction of competition within the meaning of Article 81(1) EC.

Some reinsurers have argued that this clause implies a uniformity of terms for the client which would help him in the case of a claim. They also argued that this clause would help bringing small reinsurers to submit an offer because they would benefit from the terms of the large reinsurers that could more easily evaluate the risk than they could. According to these reinsurers, this clause would thereby increase capacity on the market.

Interestingly, the French *Conseil de la Concurrence*, was consulted by the FFSA, the French insurance and reinsurance brokers association regarding the legality of a similar provision in <u>co-insurance</u> agreements. The authority has stated that this type of clause "creates a

[92] There is a need to investigate further how widespread is the utilisation of the clause in the sector, as the reinsurers' answers diverge on this point.

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"[93].

Looking at the possibility that the clause could benefit from an exemption, the *Conseil* stated that "even imagining that the clause could promote an economic progress, nothing allowed it to conclude that no other means were available in order to react rapidly and efficiently to the needs of renewing risk coverage, and nothing established *a priori* that such economic progress was proportionate to the restriction imposed on competition"[94].

According to the NMa's Financial Sector Monitor 2005, 'best terms or conditions' clauses were also used in the Dutch co-insurance market. Without explicitly questioning their legality, the NMa nevertheless notes that such clauses may have the effect of driving up prices.

10. CONCLUSIONS

This chapter raises two main issues. First, our survey shows that 91% of insurers take into account financial ratings when selecting reinsurers and that 95% of these insurers have defined a minimum rating below which they would not consider buying reinsurance from any reinsurer. This raises the question of the demand-side substitutability of the different reinsurers and thus whether ratings may affect in specific cases the definition of the product market for reinsurance provision.

The inquiry also shows that, at different stages in the negotiation of a reinsurance contract, certain reinsurance companies insert a clause to the effect of benefiting from the best terms available in the market, without quoting these terms. This "best terms and conditions" clause harmonises terms and conditions at the highest level for the reinsurers concerned, irrespective of their own characteristics, to the detriment of the reinsurance client. The clause also increases price transparency and could, under certain market conditions, amount to a restriction of competition within the meaning of Article 81(1) EC. Some respondents have advanced arguments in order to justify the practice.

[93] Avis n°03-A-19 dated 17 November, 2003, point 36 (own translation from French).

[94] *Ibid*, point 39

IX. DISTRIBUTION OF BUSINESS INSURANCE

Efficient distribution channels will determine whether business insurance clients are able to make effective and informed choices of insurance products and insurance suppliers. As previously described[95], insurance products are distributed through a variety of channels. They can be sold either directly by insurance companies, which is referred to as direct writing, or indirectly through exclusive (or "tied") agents, multiple agents, brokers, banks or other financial institutions.[96]

In most business insurance transactions there will be an intermediary between the insurance company and the party insured. The role of this intermediary varies in function of the complexity of the risk to be insured. Business insurance products tend to be rather complex products, making it difficult for clients - whether they are small and medium sized enterprises ("SMEs") or large corporate clients ("LCCs") - to fully understand, for instance, what coverage they may need, what terms and conditions of coverage are available in the market, how competing offers differ and whether the insurer they are buying from has the financial strength to pay future claims, especially in the case of so-called long-tail claims, where liabilities may only arise in the more distant future.

Agents and brokers, which are collectively referred to as insurance intermediaries under the Insurance Mediation Directive ("IMD")[97], are traditionally distinguished from each other in the following way. Insurance agents are, in general, independent contractors licensed to conduct business on behalf of insurance companies. They represent one or more insurance companies and usually operate under the terms of agency agreements[98]. There are different agency models: multiple agents working with a limited number of insurance companies; exclusive or tied agents representing either a single insurance company or selling a single line of business for each of several companies.[99] Brokers, on the other hand, represent the insurance clients and work on their behalf; in other words, in the legal sense of the term, they are “agents” of the insurance clients and not of the insurer.

In economic terms, however, the difference between brokers on the one hand and multiple agents who represent several insurers under different agency agreements on the other may not always be clear cut. Beside the placement of insurance policies with insurance companies, these two types of intermediaries may perform some of the same functions and offer similar services. They may help clients to understand and measure their risk exposure, advise them on the costs of coverage, design insurance programs and assist with claims settlements.

95 Cf. chapters III and IV.

96 Please refer to the glossary in annex for the definitions of the distribution channels used in this report.

97 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, see Article 2.

98 The IMD does not follow the agent / broker distinction as these concepts vary across Member States. The IMD does, however, include a definition of "tied insurance intermediary" (i.e. exclusive agents in the terminology of this report), and Member States (MS) are allowed to have specific requirements for tied intermediaries falling under the definition (MS may allow insurance undertakings or associations of insurers to register these tied intermediaries under the supervision of a competent authority and to cooperate with the competent authorities in the application of the requirements of the IMD. Furthermore, MS may also accept a lower level of professional knowledge for tied intermediaries). However, the definition does not prevent MS from having similar concepts of insurance intermediaries who, while acting for and on behalf of an insurer, are entitled to collect premiums.

99 Insurance companies’ own employees do not fall within the scope of insurance mediation as defined in the Insurance Mediation Directive (cf. Article 2(3), 2nd subparagraph of the IMD).

The quality of their risk assessment and the fair representation of the risk vis-à-vis insurance companies are important in obtaining competitive quotes for their clients.

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 by allowing access to a wider choice of possible insurers and by increasing the bargaining power of clients.

In the first part of this chapter, we look at the various ways in which insurance distribution is organised in the EU and the extent to which these vary in function of the different product lines and client profiles.

The second part of this chapter focuses more specifically on the role of intermediaries, especially brokers, in the business insurance market both in terms of services and of representation of insurers and of clients.

The third part deals with aspects relating to the remuneration of intermediaries.

1. Distribution Channels

1.1 Analysis of the various distribution channels in the non-life business insurance sector

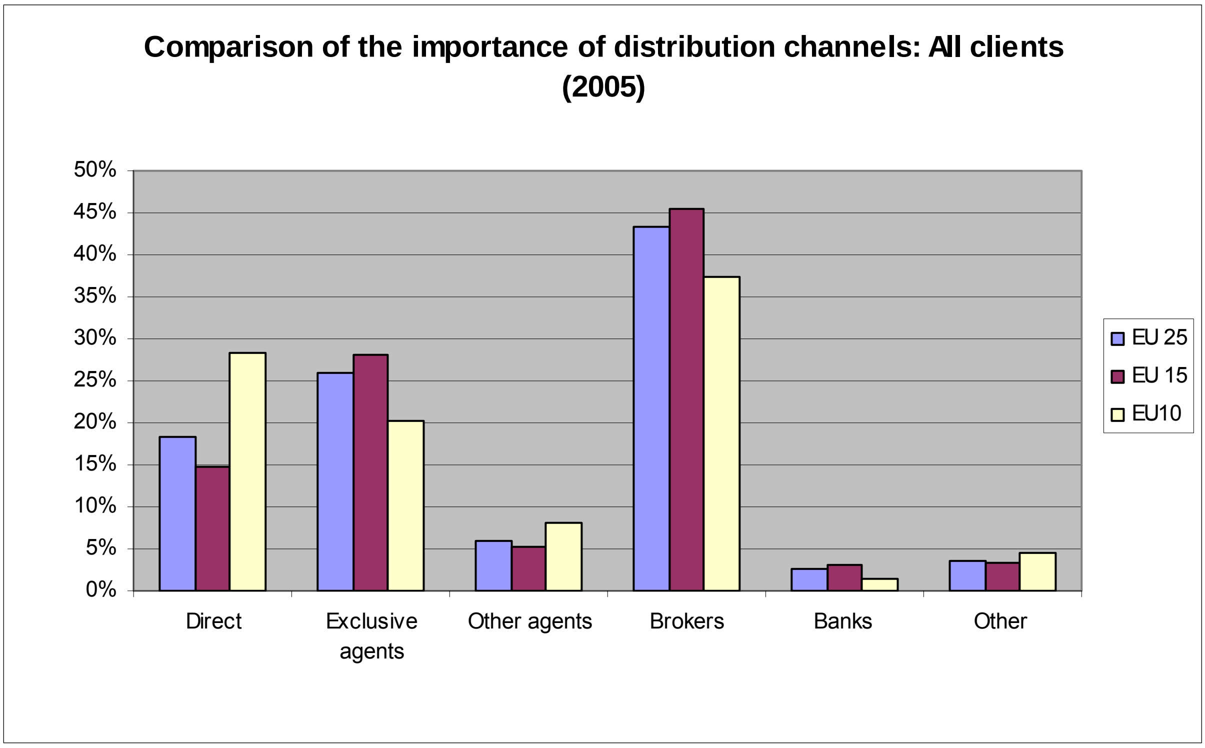
For the purpose of our inquiry we have considered that business insurance products are sold by insurers through six types of distribution channels defined along the following lines:

- **Direct writing** concerns insurance arranged between the insurer and the insured party with no involvement of an intermediary (but including insurer's employed staff and call centers),
- **Internet distribution** concerns insurance arranged by the insured party where contact and underwriting is processed directly through the insurer's website.
- **Exclusive agents** act as agents of an insurer and are under exclusive agreements to refer business to this one insurer or are otherwise constrained by agreement to refer business to this one insurer.
- **Other agents** (or multiple agents) are intermediaries who act under multiple insurer agency agreements.
- **Insurance brokers** are intermediaries that act as agent of the insured party/insurance client and that are not tied or constrained by agreement to refer the business to any insurer in particular.
- **Banks** and other financial institutions can act either as an insurance agent or as an insurance broker.

1.1.1 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 frequently used distribution channel in most lines of commercial insurance products.

Figure IX.1



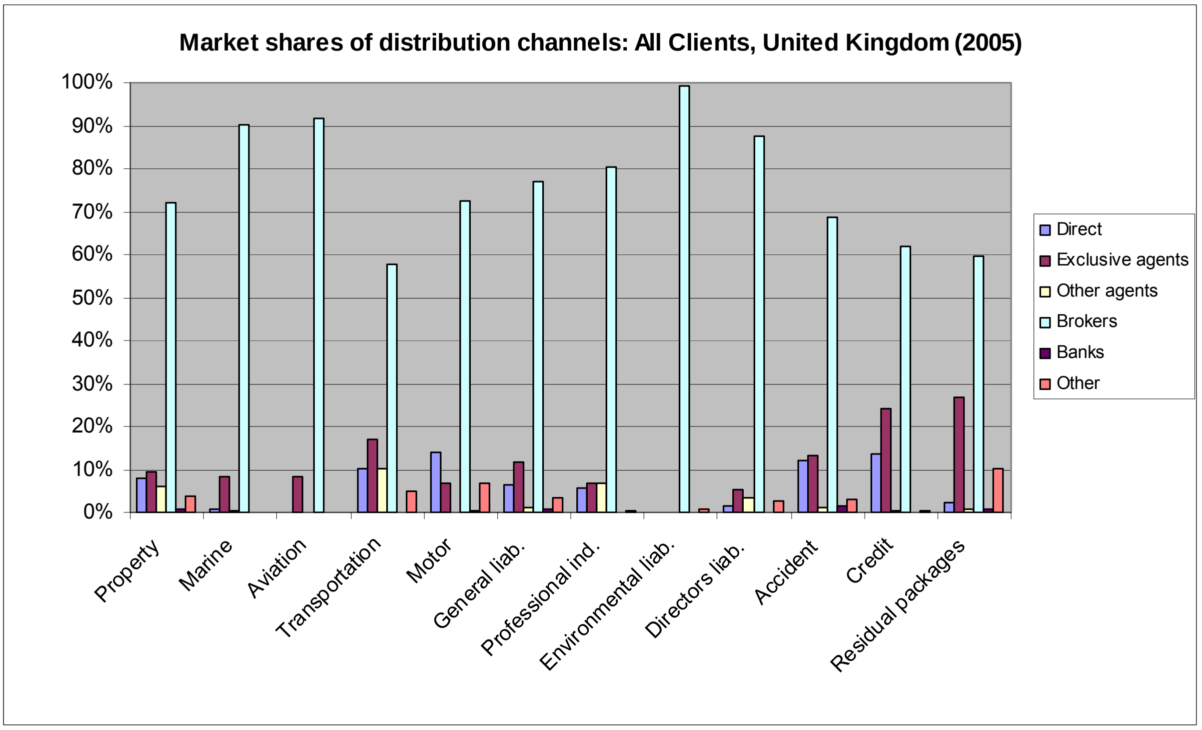
Source: European Commission, Business Insurance Survey 2005-2006

There are nevertheless distinct variations at Member State level across the EU in the choice of distribution channels.[100]

Traditionally, the broker channel is predominant in 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. The structure of the UK brokerage industry is characterized by a high market share of a small number of large international brokers and the presence of several large insurance brokers. 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 to be relatively insignificant; they are limited to a few lines of insurance such as accident insurance. In the rest of Europe the share of business conducted by brokers is also significant, but smaller.

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

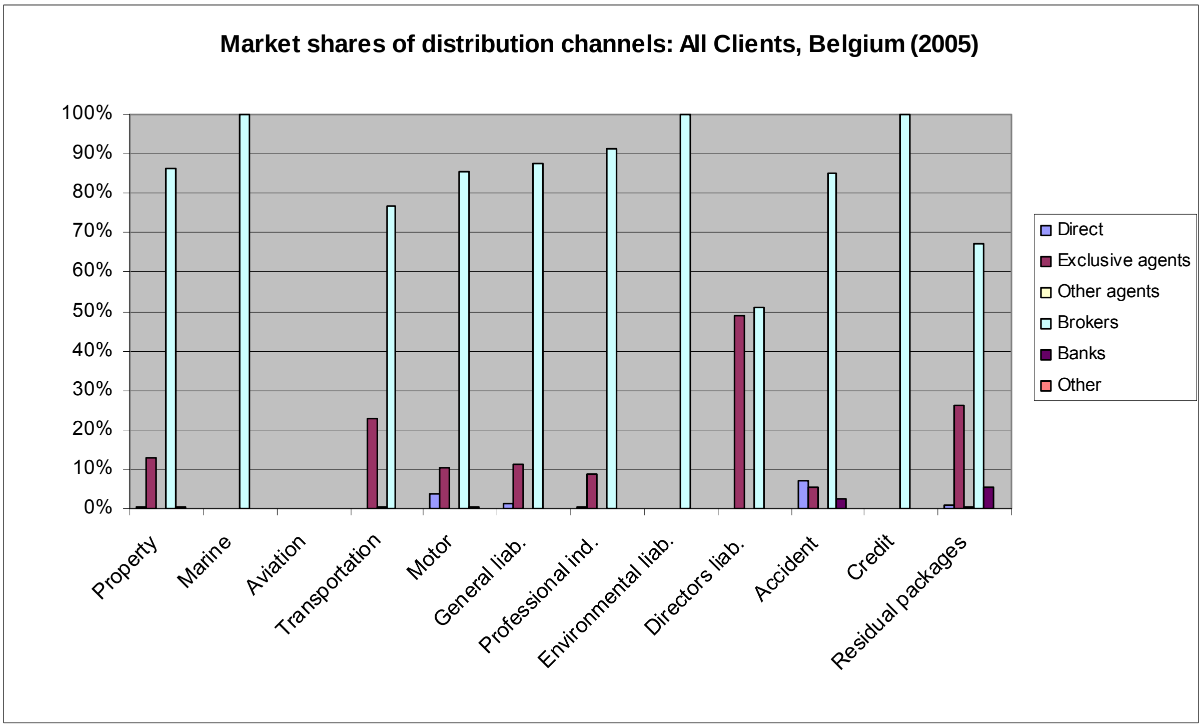
Figure IX.2([101])



Source: European Commission, Business Insurance Survey 2005-2006

[101] Please note that the abbreviations used in the figures below have the following meaning: "Property" refers to Property/Business Interruption; "General liab." refers to General Liabilities; "Professional ind." refers to Professional Indemnity/E&O; "Environment. liab." refers to Environmental Liabilities; "Directors liab." refers to Directors' and Officers' Liability; "Accident" refers to Personal Accident/Medical Expenses; and "Credit" refers to "Credit and suretyship". The definitions of the classes of insurance are provided in the glossary.

Figure IX.3

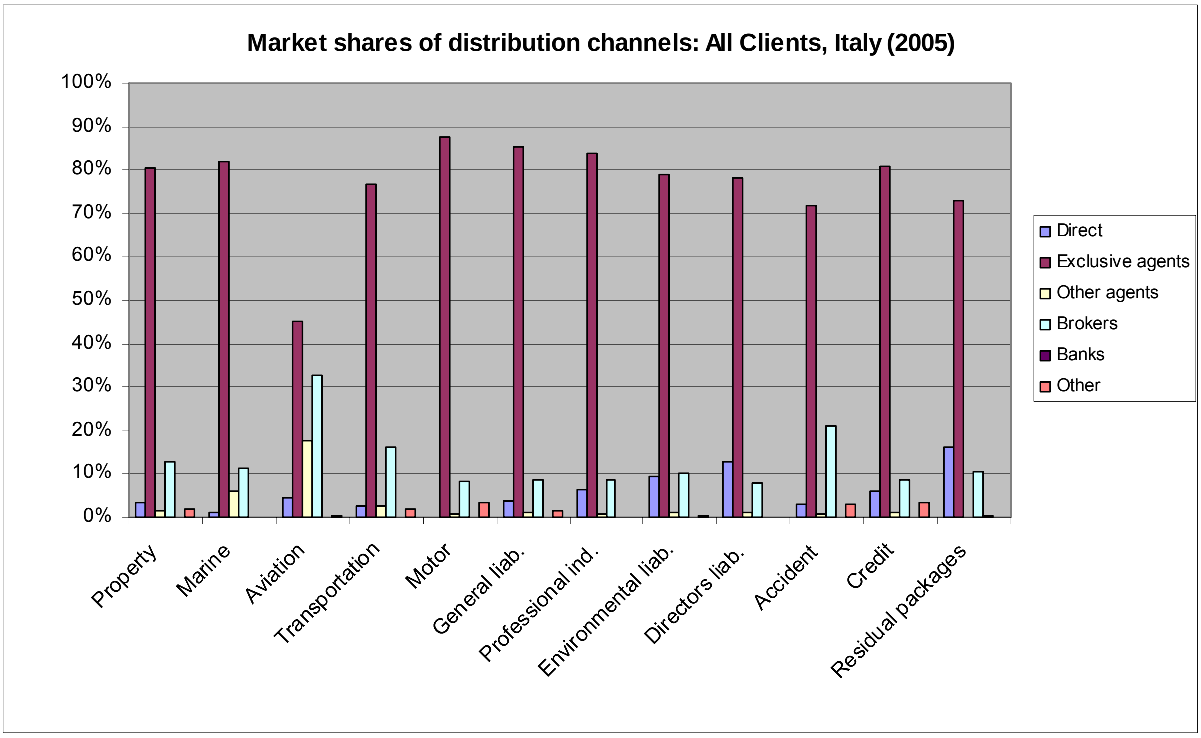


Source: European Commission, Business Insurance Survey 2005-2006

At the opposite end of the spectrum, tied agents constitute by far the most important distribution channel in Italy, maintaining a constant share of the market over time, of close to 75% on average, but which can exceed 80% in some business lines such as general liabilities, indemnity or motor insurance[102]. Germany, which is often considered to be a tied agent market as far as the placement of insurance in general is concerned (i.e. life and non-life insurance including personal lines) does not present the same pattern in respect of commercial insurance where brokers are more highly represented.

102 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. Cf. Swiss Re, Sigma No 2/2004, 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 channelled 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." The importance of the brokerage channel is also more significant in respect of the Energy, Marine and Aviation product lines.

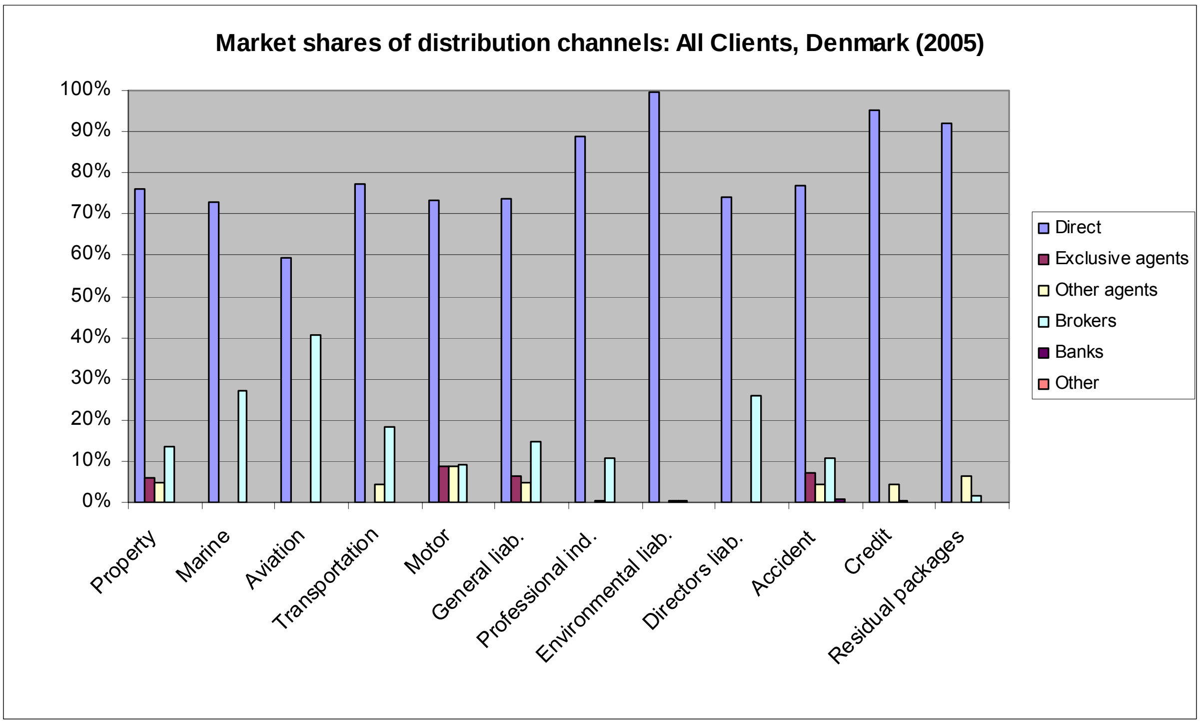
Figure IX.4



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 appealing distribution channel, because it may be less costly and could also allow for more stringent controls on 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.

Figure IX.5



Source: European Commission, Business Insurance Survey 2005-2006

Overall, banks and other financial institutions are only a minor distribution channel for business insurance products in Europe, while being dominant in the distribution of life insurance products 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' ability to exploit existing customer relationships for cross-selling.[103]

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.

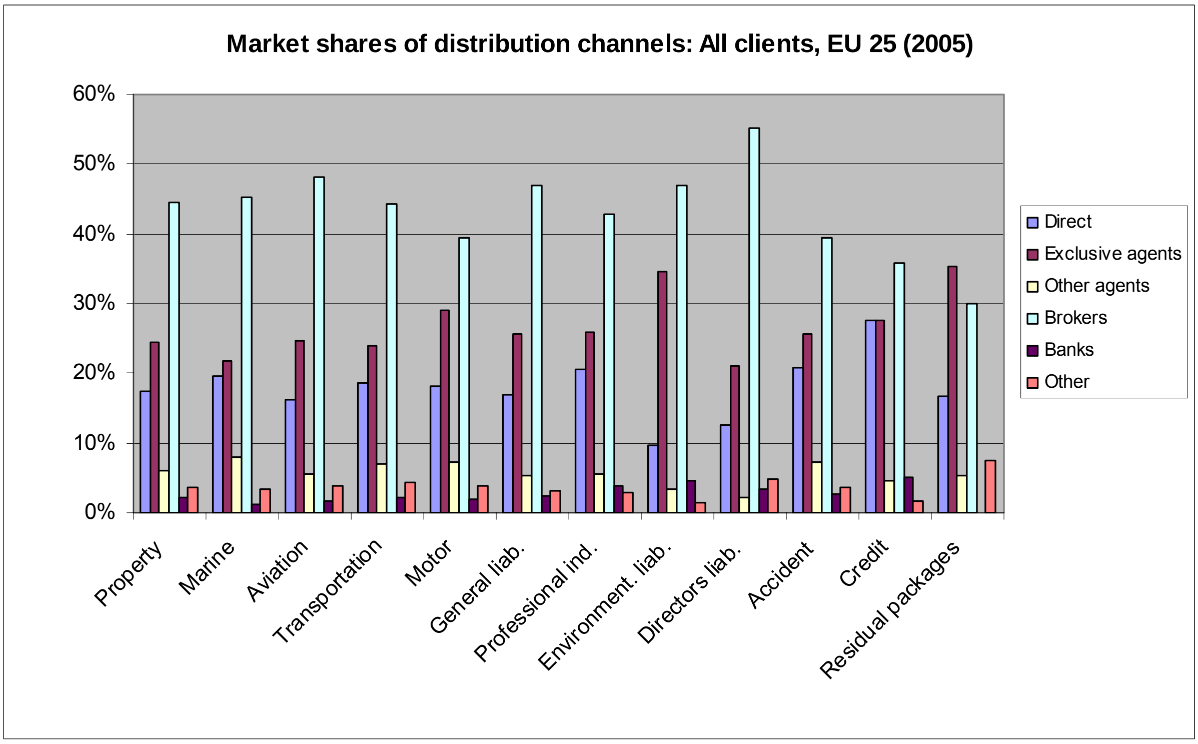
The present inquiry nevertheless shows a significant presence of banks in the distribution of certain lines of business insurance in some countries such as the Netherlands or Spain. However, this appears, mainly, to be confined to the distribution of certain standardised insurance policies to small businesses responding to straightforward insurance needs.

1.1.1.1 Differences in the importance of the various distribution channels according to product 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. As a result, this category of intermediaries has a greater role to play, in analyzing the potential risk exposure, securing adequate coverage and possibly providing other services. On the other hand, exclusive agents and direct writing play a more important role in less complex products such as motor insurance, a sector, in which banks are, in general, also comparatively more active.

103 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, published on the Commission's website.

Figure IX.6



Source: European Commission, Business Insurance Survey 2005-2006

1.1.1.2 Differences in the importance of the various channels according to client profiles

The most noticeable differences can be found in relation to the profiles of the clients. The inquiry confirms the predominance of the broker channel for large corporate clients and, consequently, a lesser role for direct sales or sales through tied agents. Furthermore, 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 they have 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[104]; 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 that have their own captive brokerage department ("in-house broker") place business directly with insurers, they often still use independent brokers at the same time because of the different services they offer.

By comparison, and as shown by the two figures below, distribution through exclusive agents is more largely represented in SME business.

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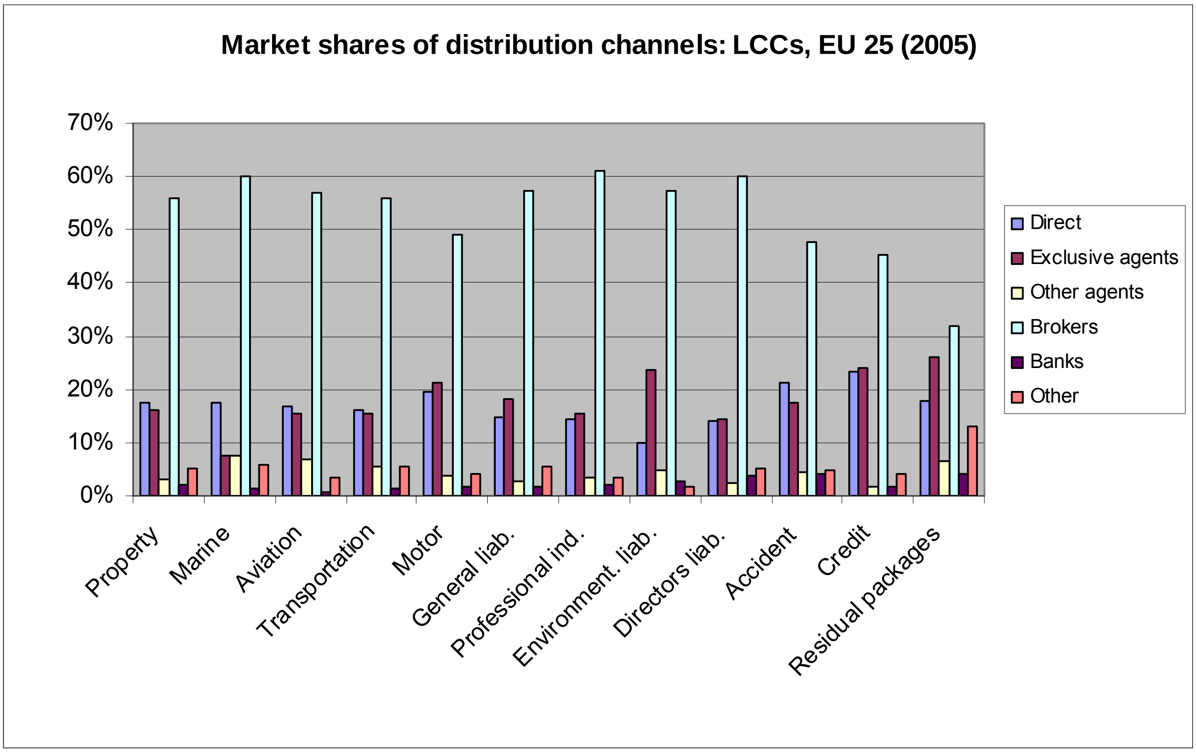
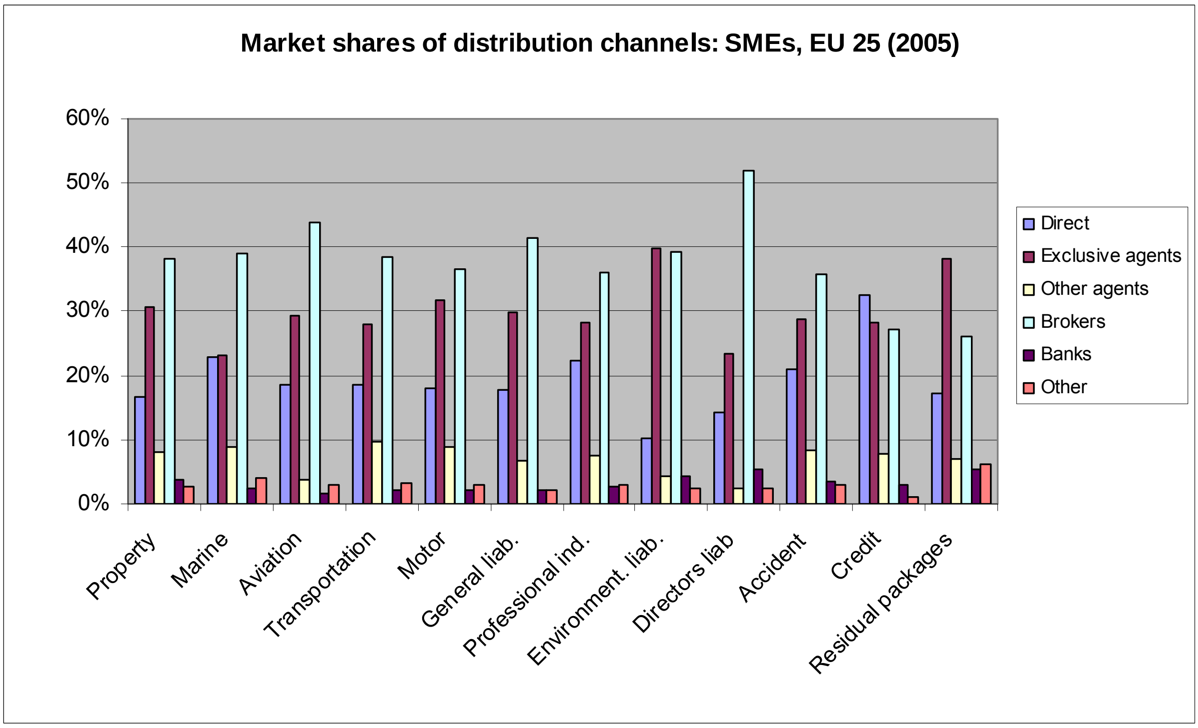
[104] Please note that besides the global brokers that are represented in many foreign markets through group companies, there are also networks in which medium-sized brokers co-operate in order to be able to service their clients internationally. Please see chapter 5 for some figures on intermediaries' placing business internationally for their domestic clients.

Figure IX.7



Source: European Commission, Business Insurance Survey 2005-2006

Figure IX.8

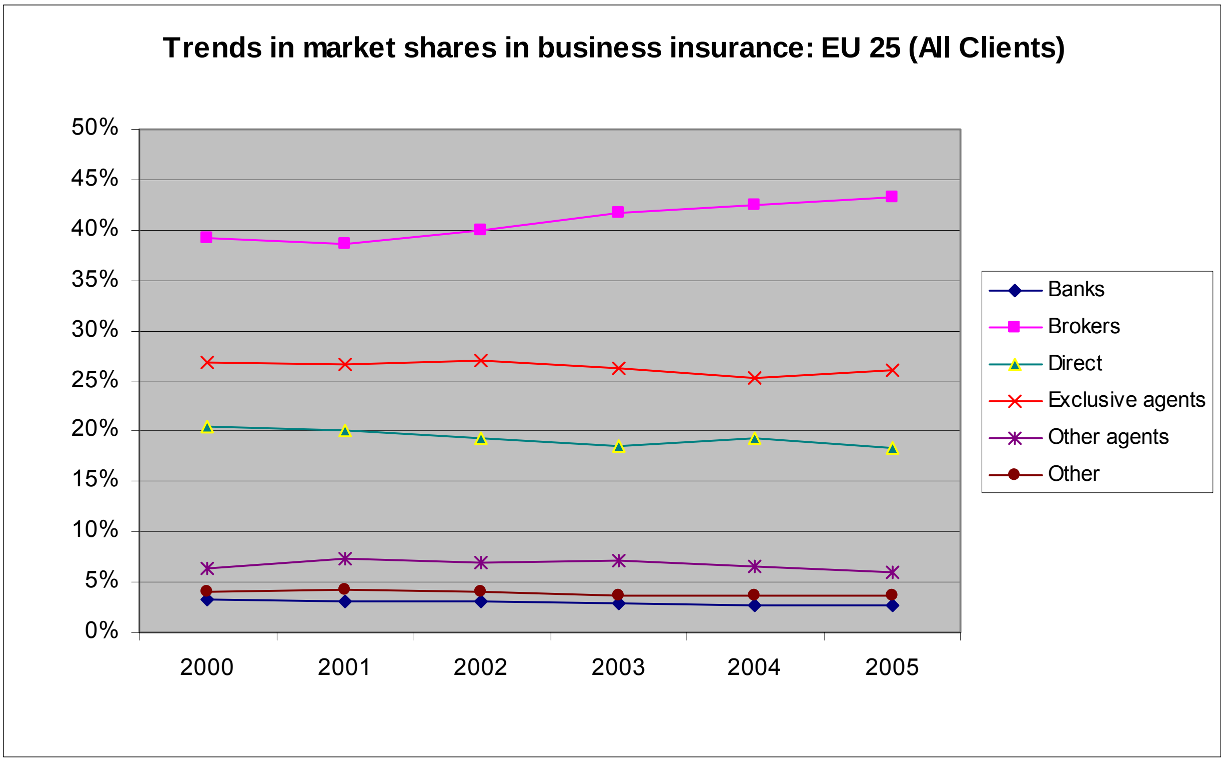


Source: European Commission, Business Insurance Survey 2005-2006

1.1.1.3 Variations and trends over the last five years at EU level and in the Member States

Looking at all lines of business aggregated at EU level, the results of our inquiry show only limited variations in the importance of the different distribution channels for the period 2000-2005, with a slight increase in the broker channel at the expense of the others.

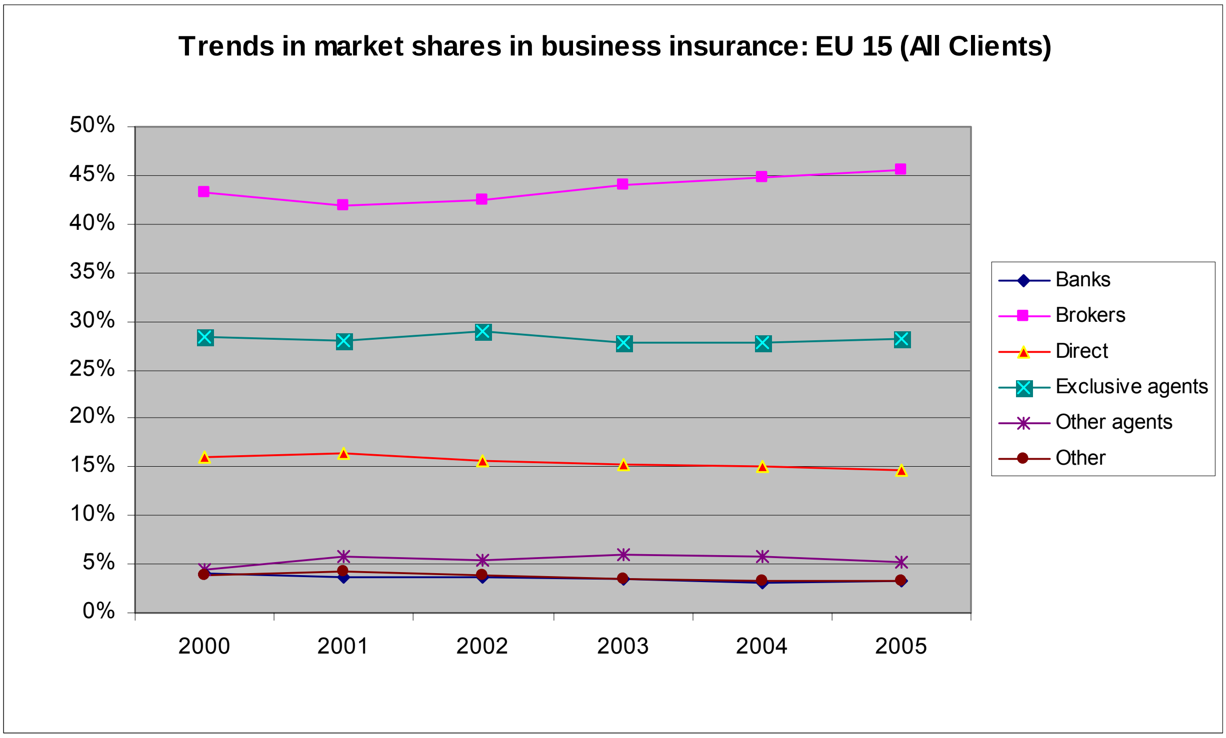
Figure IX.9



Source: European Commission, Business Insurance Survey 2005-2006

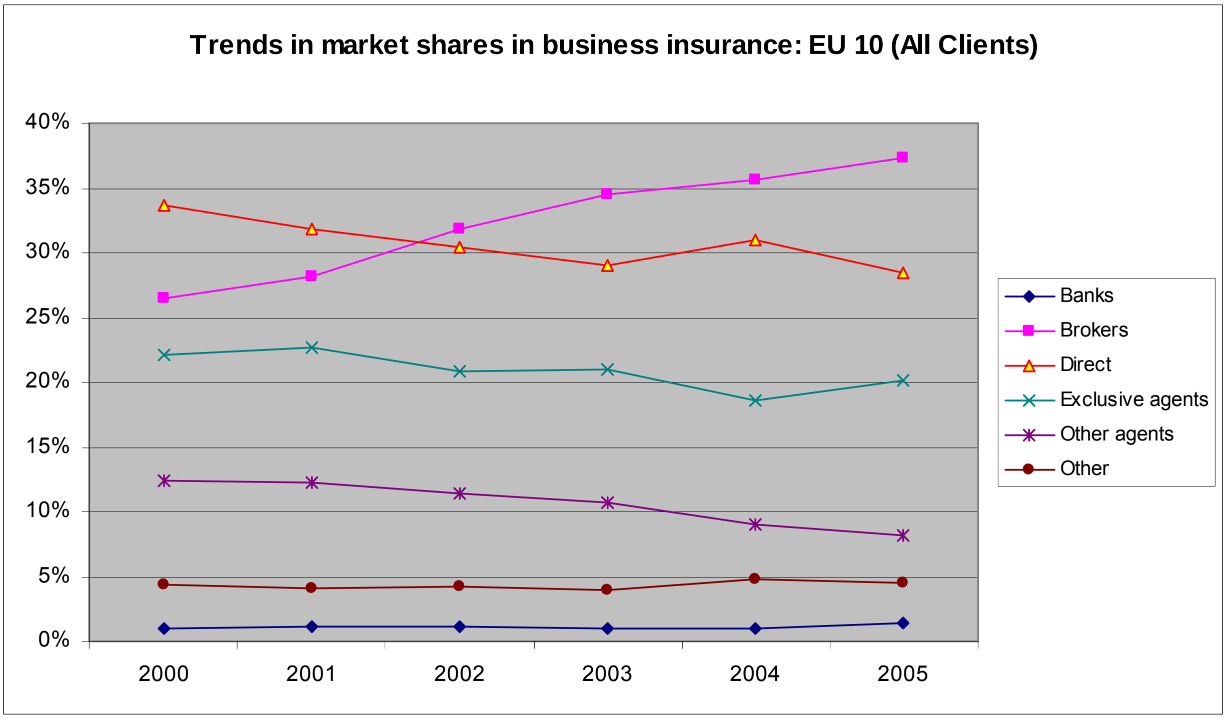
Such relative stability is even more apparent at the level of the EU-15, whereas the most noticeable changes have occurred in the Member States that joined the EU in 2004, where a decrease in direct writing and distribution through agents can be observed to the benefit of the broker channel.

Figure IX.10



Source: European Commission, Business Insurance Survey 2005-2006

Figure IX.11



Source: European Commission, Business Insurance Survey 2005-2006

1.1.2 Competition considerations in relation to the structure of distribution in the Nordic countries

Swedish, Danish and Finnish insurers are presently obliged by law to quote on a net basis. In Finland, for example, the new Finnish Insurance Mediation Act (570/2005) which entered into force on 1 September 2005, has introduced a prohibition on the payment of commissions by insurers to brokers. Brokers are now supposed to obtain their remuneration exclusively from the client. In Denmark the law changed in mid-2006, but prior to this change, Danish insurance companies already did not pay commissions to brokers and quoted on a net basis.

According to brokers established in these countries, net quoting will have adverse effects on the broker distribution channel. They claim that the net quote system may unfairly favour the insurers' in-house sales forces and agents to the competitive disadvantage of brokers.[105] The impact of the system on the profitability of brokerage firms could lead to consolidation of the brokerage industry or possibly to relocation to other Member States, as was reported in one case. According to this line of argument, in the long run brokers would progressively be driven out of the market and clients would have more difficulty in obtaining independent service and advice.

The obligation of net-quoting could also 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 would 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. Moreover, given the relatively small size of the markets concerned, the question arises as to how many fully-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 yet be drawn as this practice is relatively recent.

1.2 Exclusive agents

1.2.1 Significance of this distribution channel

The distribution of commercial insurance through exclusive agents appears to be the second most popular choice of insurers across Europe, as shown in Figure IX.1. This model is predominant in Italy, where at least 70% to 80% of non-life commercial insurance products are sold through tied agents. Tied agents also have significant market shares in Germany and France. In Cyprus, a large percentage of the business of insurance companies is also highly dependent on exclusive sales agents, in particular as far as motor insurance is concerned.

1.2.2 Duration of the exclusive relationship

By its nature, an agency contract is a long-term service contract. It can be concluded for a limited period of time, but it is common that exclusive agency agreements are concluded by insurers for an indefinite period. This means that the agency relationship can be terminated by either side by giving notice to the other party. When the agreement has been concluded for a fixed term, its duration rarely exceeds 1 to 5 years. Such contracts expire automatically at the end of the term unless the parties continue operating as if the agreement was still in effect after

[105] Brokers have stated that the net premiums quoted by insurers are unreasonably high, as insurers do not necessarily reduce the premium by the full amount of commissions that would otherwise have been paid. Amounts retained by the insurers' own sales forces in the form of commission fees for business introduced are not disclosed by insurers.

the expiry of the fixed term, turning them effectively into an indefinite duration agreement, which can be terminated at any time upon notice.

1.2.3 Restrictions on termination of exclusive agency agreements

Our inquiry did not show the existence of specific restrictions on the termination of exclusive agency agreements going beyond the restrictions imposed by EU Directive 86/653/EEC of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents[106] and the laws or regulations which have harmonised the laws of EU Member States by conferring agents with a minimum level of protection and security in terms of notice period and rights to compensation or indemnity.

Agency agreements concluded for an indefinite period can only be terminated subject to a minimum period of notice given by either party. Such notice must not be less than 1 month for each year of the duration of the agreement up to a maximum of 3 months' notice for agreements of 3 years or more. The parties can agree on a longer notice period. However, the survey has not shown the prevalence of excessively long periods for terminating agency agreements as a rule.

Agents are also entitled to compensation or an indemnity upon termination of the agency agreement. The parties are free to choose which of these options will apply. In case no option has been chosen, the insurer will owe compensation to the agent upon termination of the agreement based on the amount of commission earned by the agent in previous years. This does not apply if the agent terminates the agreement, unless the termination is justified by circumstances attributable to the insurer or by other exceptional circumstances. Depending on the duration of the agreement, the amount of the indemnity or compensation to be paid can reach appreciable levels. This can be an important reason for the agent not to terminate the exclusive relationship with the insurer, as he may otherwise lose his compensation.

1.2.4 Competition considerations in relation with tied-agent networks

Under certain circumstances, the existence of networks of exclusive agents tied by non-compete obligations can 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 not sufficient to characterise a finding of foreclosure - it would have to be appreciated in the light of market structure and other circumstances.

The German retail insurance market, which is considered to be an illustration of this type of distribution structure, has been examined by the Commission in the past. The level of tied market share in itself was representing in this case approximately 65% of the insurance products. However, this particular market showed considerable inter brand competition due to the existence of a large number of competitors, a relatively low concentration, an increasing variety of products and an increased readiness to switch insurers.

2. Role of the intermediaries

Typically, brokers have a strong market position in servicing corporate clients with complex and large exposure. Small commercial risks are to a larger extent placed through agents or underwritten directly by the insurer.

Brokers scan the market, match buyers with insurers who have the skill, capacity and financial strength to underwrite the risk, help clients to select between competing offers and

[106] OJ L 382, 31.12.1986

assist their clients with claims settlement. To a certain extent, multiple agents may perform some of the same functions for their clients.

More specifically, the insurance broker analyses the risk situation and needs of his client in terms of, for instance, risk to be retained, risk cover and level of services to be provided by the insurer. In this respect, the broker has a dual role as an advisor of his client but also as a distribution channel for insurers. This could lead to some tensions between the objectivity of the advice given and commercial considerations, which emanate, in particular, from remunerations obtained from the insurer or from the services provided to the insurer. The provision of some of these services may be more prone to lead to conflicts of interest.

2.1 From traditional core services to new services

The brokerage sector as such is not homogeneous. It is sometimes regarded as divided into sub-sectors according to the size or specialization of the brokers. The scope of the activities undertaken by the brokers and the range of services provided by them will determine the type of clients they serve. Major multinational or large national companies are often served by global brokers who operate on a large international basis and who offer a vast range of specialised (payable) services to their clients. Large to medium sized companies are also served by major domestic brokers. Smaller brokers can either be regional brokers, serving small businesses, or ‘niche’ brokers interacting with other brokers and having specialised expertise in certain industries or types of risks.[107] This does not mean, however, that there cannot be competition between brokers from the different sub-sectors.

According to Swiss Re[108], the role of brokers has evolved over the last two decades. It has developed from the role of a market-matcher, whose services relate to transferring risk from clients to insurers, to the role of a service provider to both clients and insurers. Matching clients’ insurance needs with insurance supply includes, inter alia, the assessment and analysis of the risks, market research and analysis as well as the structuring and negotiation of insurance programs. The development of brokers’ roles can be seen in the multitude of fee-based risk management and consultation services that some brokers offer nowadays.[109]

2.2 Range of services provided to clients across Member States

For the purpose of the present inquiry the services provided to clients have been defined as follows:

- **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 that are separately charged relating to the management of claims to insurance placement clients.
- **Loss assessment**: Representation of claimants, for whom the broker did not place the insurance being claimed upon, in formulating claims and securing payment.
- **Legal services**: Provision of legal advice, whether related to insurance matters or other issues, in exchange for a separate fee.

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[107] Another distinction can be made between “retail brokers”, who deal directly with clients, and “wholesale brokers,” who may place risk in international markets, cf. also Swiss Re Sigma No 2/2004, page 11 et seqq., and World Federation of Insurance Intermediaries (2005), Role of Intermediaries.

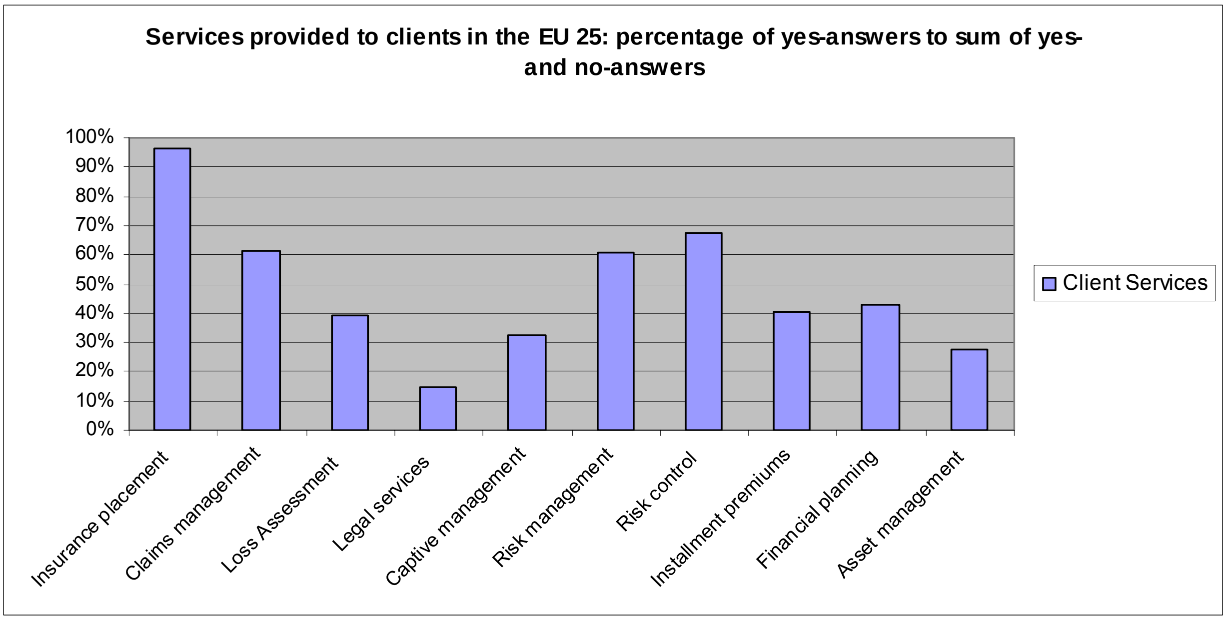
[108] Cf. Swiss Re Sigma No 2/2004, page 8 et seqq.

[109] For details and examples, cf. Swiss Re Sigma No 2/2004, p. 8. et seqq.

- **Captive management**: The establishment and management of captive insurance companies on behalf of insurance placement clients, including such services to the clients of other insurance intermediaries.[110]
- **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.
- **Instalment premiums/premiums credit**: Provision of instalment 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**: Provision of financial advice, including investment, pensions and mortgage/loan advice, for third parties, whether individuals or legal entities.
- **Asset management**: Provision of transactional services related to investments and mortgages/loans for third parties, whether individuals or legal entities.

The following figures show the percentage of positive answers to the question of which client services the group to which the intermediary concerned belonged provided in 2005.

Figure IX.12



Source: European Commission, Business Insurance Survey 2005-2006

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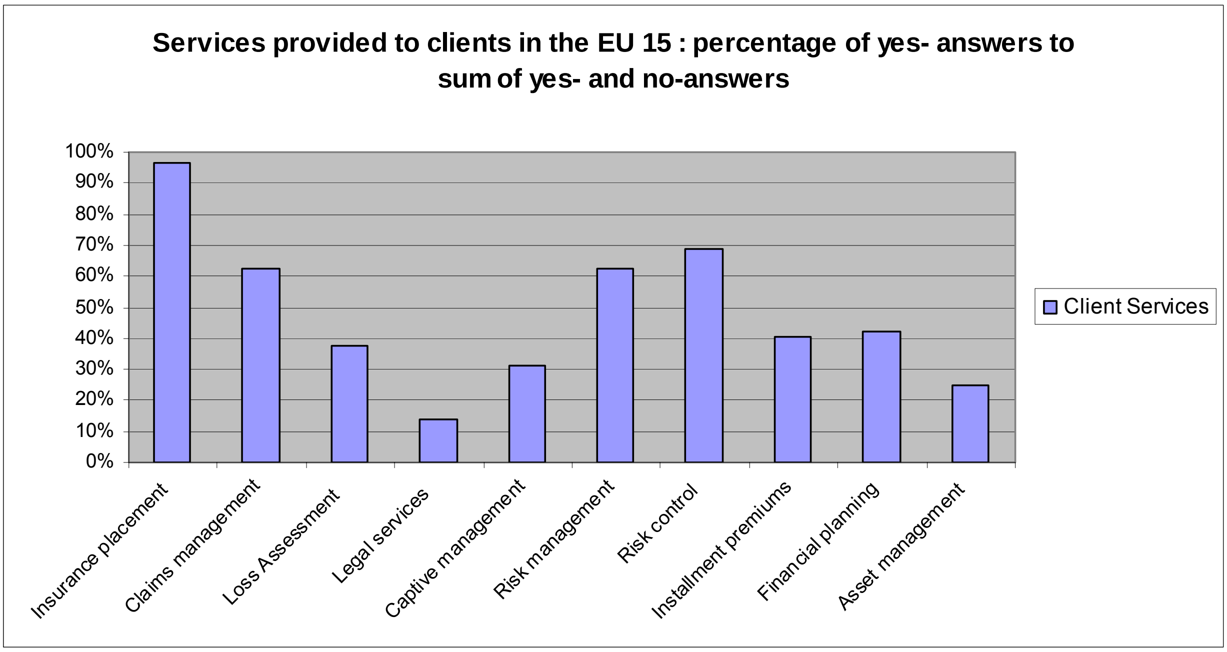
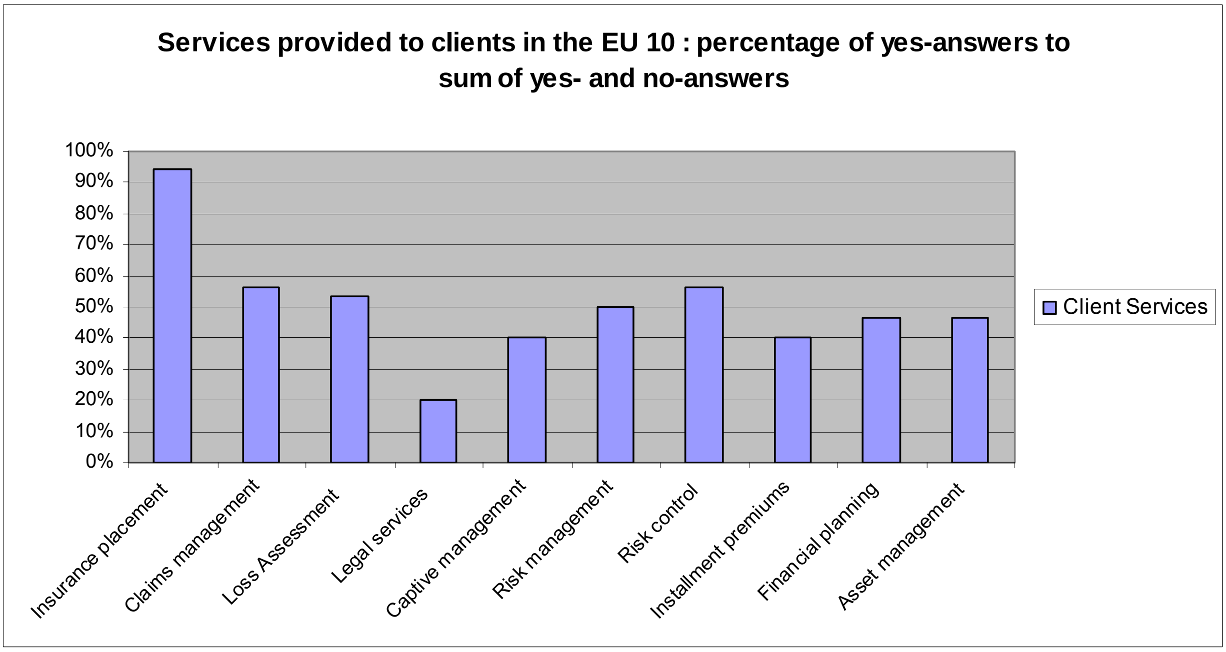
110 Captive insurance companies are insurance companies wholly owned by a non-insurance group, typically a large company or group of companies in another business. The primary purpose is to insure or reinsure the risks of the parent group. Intermediaries may help a client to establish a captive and/or manage the captive once it is has been established.

Figure IX.13



Source: European Commission, Business Insurance Survey 2005-2006

Figure IX.14



Source: European Commission, Business Insurance Survey 2005-2006

Brokers are not allowed in all Member States to give legal advice. In Germany, brokers are prevented from doing so by the German "legal advice act" (*Rechtsberatungsgesetz*), and according to a number of court judgements brokers cannot assist municipalities and other public buyers with legal advice in the procurement of insurance coverage. According to the German *Rechtsberatungsgesetz*, insurance brokers are only allowed to give "legal advice" to their clients on an ancillary basis to their main service, the broking activity. Only insurance advisers are entitled to request the permission needed in accordance with the *Rechtsberatungsgesetz* to advise clients independently of any broking activity, i.e. as regards the closure, change or review of insurance contracts.

2.3 Range of services provided to insurers across Member States

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 rely on accurate information about the risk in question. As brokers rely on long-term relationships with both insurers and clients, they should generally have an interest in avoiding opportunistic behaviour and in providing a fair representation of the client's risk, in order to obtain a number of competitive quotes for the client.[111]

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 in submitting a competitive bid. This can explain a large disparity between bids submitted. Some brokers have acquired the ability to provide highly sophisticated services such as risk modeling or risk surveying, which are offered to interested insurers for a fee.

For the purpose of our inquiry we have defined the services provided to insurers 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, which includes all or any of the setting of terms and premiums, binding of cover and agreement of claims.[112]
- **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.
- **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.

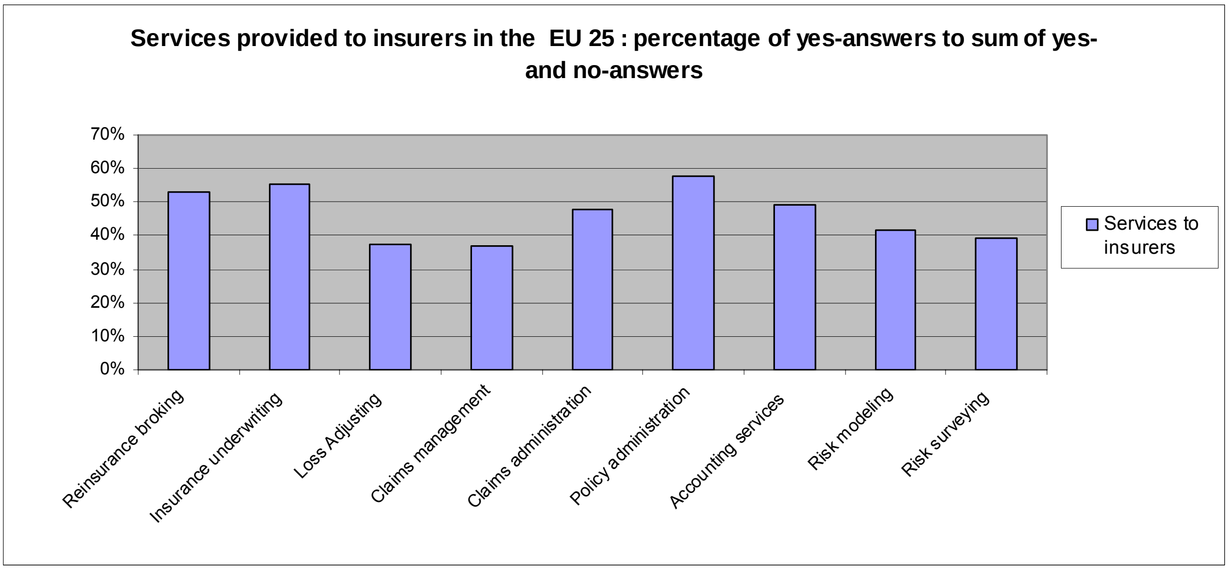
[111] In section 3 we will examine how certain aspects relating to remuneration may lead to a conflict of interest on the part of brokers.

[112] Revenue from this had to be reported by participants in the survey including profit commissions paid by insurers on client portfolios or segments thereof.

- **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.

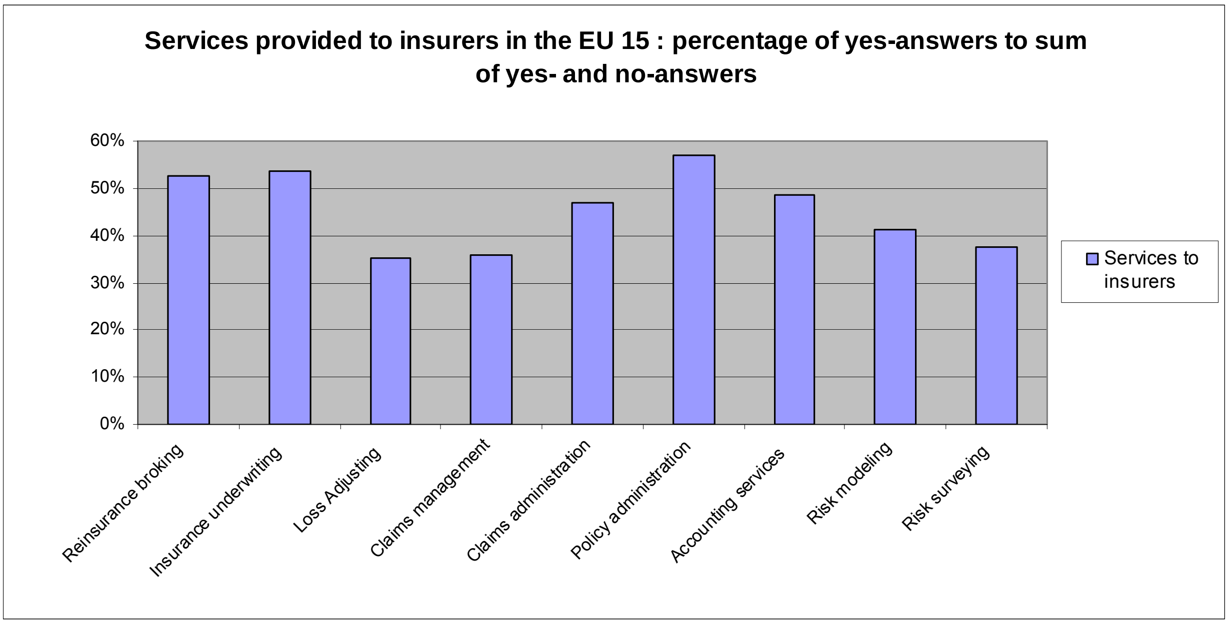
The following figures show the percentage of positive answers to the question of which services to insurers the group to which the intermediary concerned belonged provided in 2005.

Figure IX.15



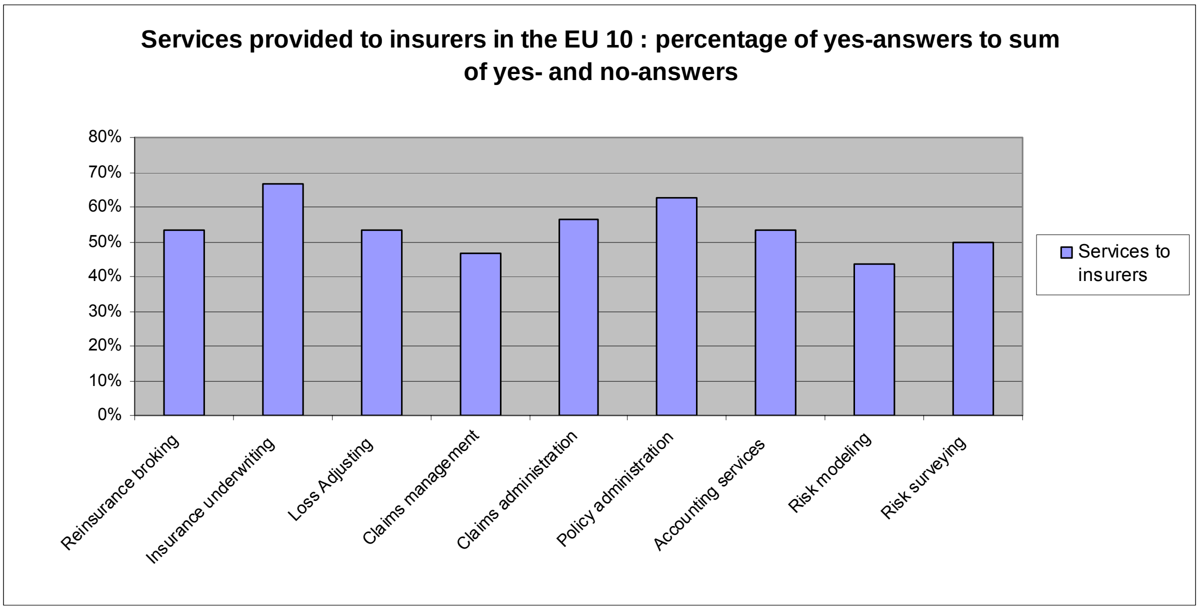
Source: European Commission, Business Insurance Survey 2005-2006

Figure IX.16



Source: European Commission, Business Insurance Survey 2005-2006

Figure IX.17



Source: European Commission, Business Insurance Survey 2005-2006

2.4 Placement patterns

Brokers work on average with a large number of insurers.[113] But this number varies according to the size of the broker, the scope of the broker's business activities and also the size

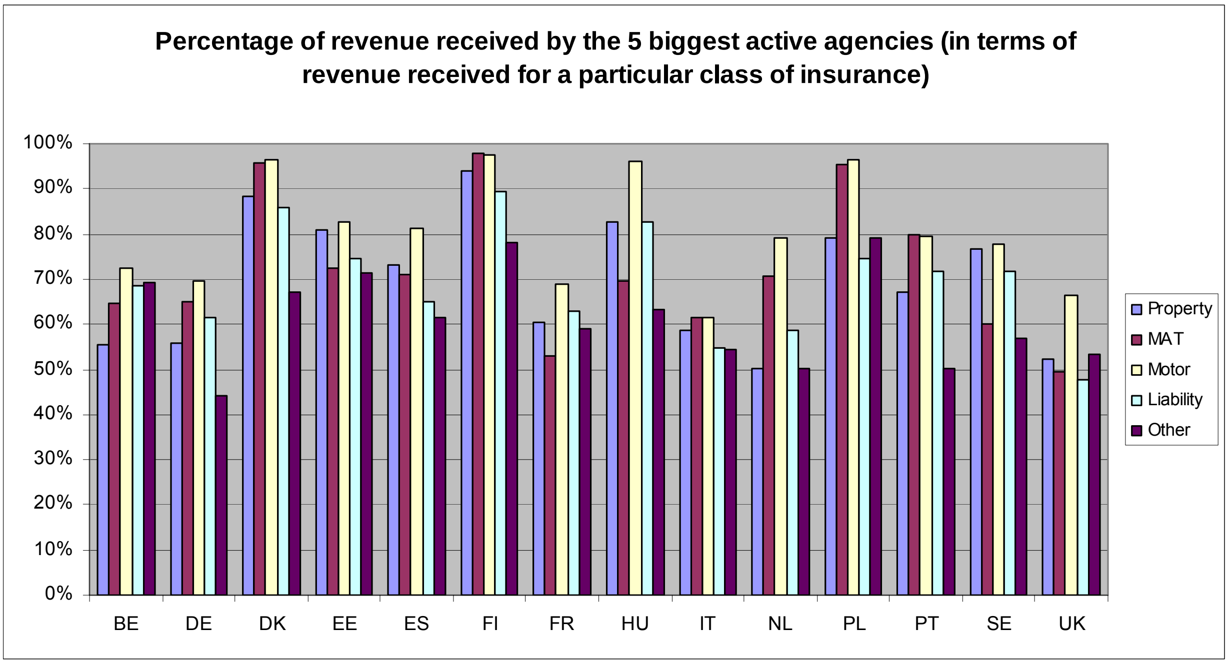
[113] In the survey of intermediaries, respondents were asked to provide information on the number of insurers with whom they place commercial insurance. A distinction was made between "agencies" and "active agencies". For a definition of these terms please refer to the glossary at the annex.

of the market the broker is operating in. There is obviously no comparison possible between a large global broker that works with several hundred insurers and a small regional broker acting in an emerging market which will actively represent a maximum of five to ten different agencies.

Taking this into account and looking at the average percentage of revenue achieved with the five to ten biggest active agencies[114] for each product line, our findings show a high concentration of business placed by brokers with the first five active agencies in most lines.

This phenomenon is particularly pronounced in Denmark, Finland, Hungary and Poland. On the other side of the spectrum, a higher degree of diversification seems to be achieved by brokers in the UK and Italy, and to a lesser extent in Germany and France. In terms of revenue received over all classes the business of brokers from the UK and Italy is also spread over a wider base of insurers.

Figure IX.18([115])

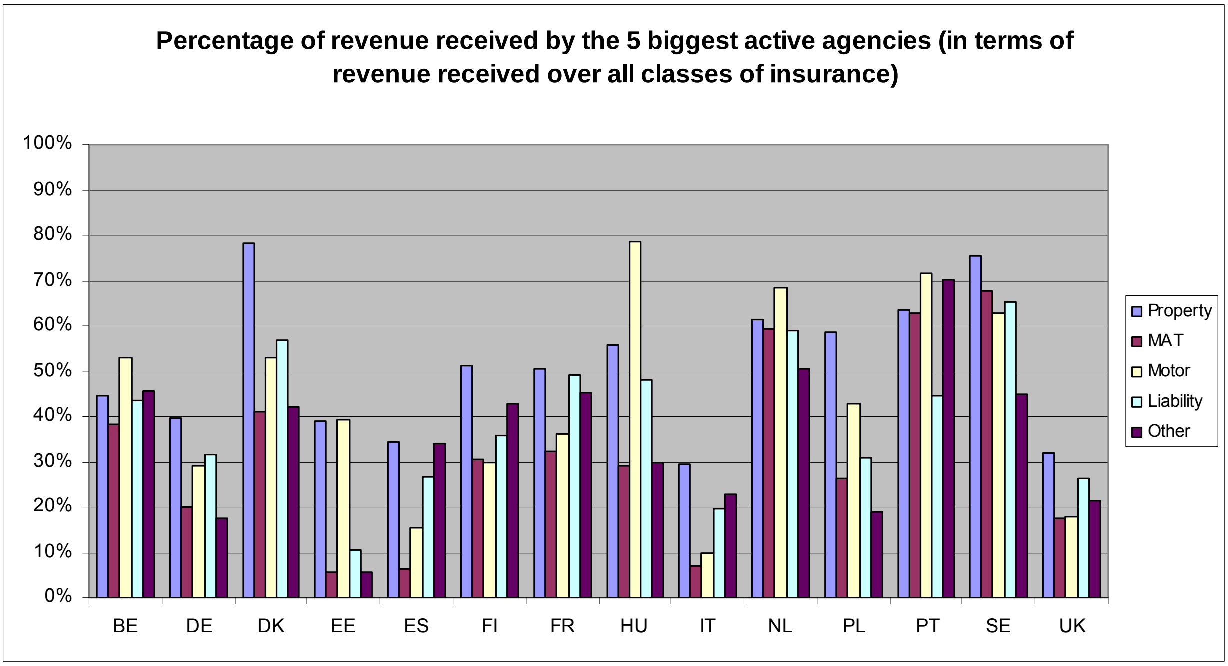


Source: European Commission, Business Insurance Survey, 2005-2006

[114] The term active agency was defined in the questionnaires as the relationship with an insurer with whom the intermediary did actually place business in the reference period, excluding any revenue/activity in respect of prior years/adjustment of prior year placements.

[115] The acronyms for the individual Member States are explained in the glossary.

Figure IX.19

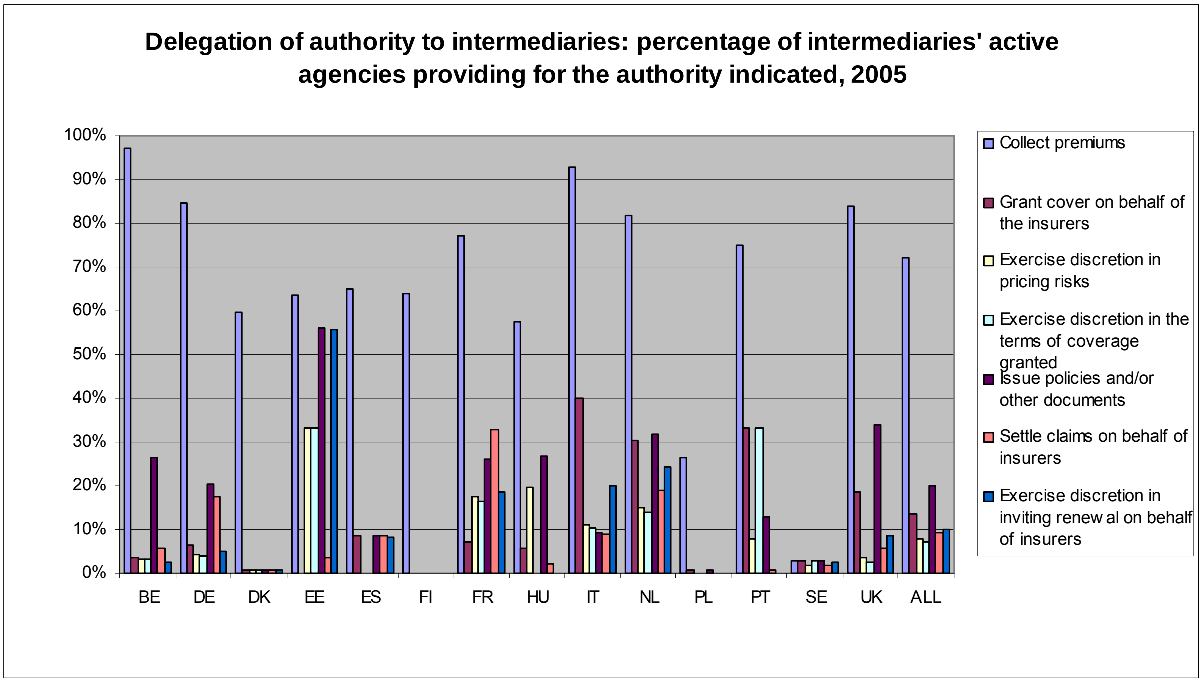


Source: European Commission, Business Insurance Survey, 2005-2006

2.5 Scope of intermediaries' responsibilities under authorised agencies

As mentioned above, intermediaries may act for or on behalf of insurance companies in a number of ways. In our survey of intermediaries we have looked at certain specific delegations of authority, namely the collection of premiums, granting of cover on behalf of insurers, the exercise of a certain discretion in the pricing of the risks, the issuance of policies and/or other documents, the settlement of claims on behalf of insurers and lastly, the exercise of a certain discretion in inviting the renewal of policies.

Figure IX.20



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

2.6 Determinants of intermediaries' insurer choice

A number of factors determine the recommendation that brokers make to their clients when advising them on the choice of a particular insurer. Apart from the price quoted for the risk in question, these factors may include, inter alia, the breadth of coverage available, the flexibility of the insurer in agreeing coverage, the image and reputation of the insurer especially in respect of claims service (speed, generosity of settlements, additional benefits to claimants) the insurer's financial security, the quality and clarity of documentation provided, the speed of the insurer in issuing documentation or in quoting terms, timeliness in inviting renewal, the technical competence of the insurer's staff, the quality and availability of advice provided to policyholders, the quality of the other services provided by the insurer, its nationality or location.

Looking at three specific classes of insurance, namely property/business interruption, MAT[116] and general liability, the survey of intermediaries has established that the importance of the above determinants of choice varies little in function of whether the client is an LCC or an SME. The survey also does not show any significant difference between the Member States. The price quoted for the transaction, the insurer's financial security and the breadth of coverage available rank first in all cases. The flexibility of the insurer in agreeing coverage, claims services and technical competence of the insurer's staff are equally important in the choice of the insurer.

Most of the intermediaries surveyed stated that the amount of the commission or any other form of financial remuneration provided by the insurer was of little or no importance for their recommendation of a particular insurer to the client. The potential for conflicts of interest was, however, highlighted in a few cases, where respondents stated that the remuneration provided by insurers was a very important factor for their recommendation of a particular insurer. In a number of these cases the same respondents also indicated that they do not

[116] Marine, Aviation & Space, Transportation

spontaneously disclose the commission earned on the insurance business arranged for the client.[117]

Figure IX.21

DETERMINANTS OF CHOICE (EU 25)	Property/ Business		MAT		Liability	
	SMEs	LCCs	SMEs	LCCs	SMEs	LCCs
Breadth of coverage available	8	10	8	9	9	10
Flexibility of the insurer in agreeing coverage	8	9	8	8	8	9
Price quoted for the risk in question	9	9	9	9	9	9
Commission or other remuneration provided by the insurer	2	2	2	2	2	2
Claims service	8	8	8	8	8	9
Quality and clarity of documentation provided	7	7	7	7	7	7
Speed of insurers in issuing documentation	6	6	6	6	6	6
Speed of insurer in quoting terms	7	7	7	7	7	7
Insurer financial security	9	9	9	9	9	9
Timeliness in inviting renewal	6	5	6	5	6	5 to 6
Technical competence of insurer's staff	7	8	8	8	8	8
Quality and availability of advice provided to policyholders	6	7	6	7	6	7
Quality of other services provided	5 to 6	6	6	6	6	6
Nationality/location of the insurer	5	4	5	4	5	4
Brand, image and reputation of the insurer	7	7	7	7	7	7

Source: European Commission, Business Insurance Survey 2005-2006

2.7 Information provided by intermediaries to their clients when recommending cover and choice of insurer

The information provided by intermediaries to their clients may include the price quoted for the risk in question, the number of insurers approached for quotes, the range of prices quoted, information on the financial security of the insurer(s), information on the relative breadth of the coverage offered , information on the quality of the claims service provided by the insurer (e.g. speed and generosity of settlements, additional benefits provided to claimants), commission or other remuneration received from the insurer(s), information on the nature and quality of other services provided by the insurer(s), information on the quality and clarity of documentation provided by the insurer, information as to the timeliness of the insurer in inviting renewal.

The nature and frequency of the information provided by brokers to their clients varies as shown in the table below, and is also a function of whether the client is an SME or an LCC. These differences can be further observed at national level where LCCs appear to be generally better informed by their brokers, regardless of the type of information concerned. This is particularly visible in Belgium, where brokers appear to limit the information they provide to SME clients to the price quoted and breadth of coverage.

Countries where clients benefit the most from broad and extensive information provided by brokers are, in order of importance, Denmark, Sweden and Finland. In comparison, UK brokers seem, in general, the least inclined to provide information to their clients. The two following tables indicate the types of information which intermediaries provide to their clients when recommending cover and the insurer with whom the risk should be placed. The numbers have the following meaning: 1: never, 2: rarely, 3: sometimes, 4: most of the time, 5: always.

117 The subject of conflicts of interest is discussed in more detail in section 3 of this chapter.

Figure IX.22
Degree of disclosure per type of information

Information provided by brokers to their clients at EU level	Average ranking from 1 (never) to 5 (always) SME	LCC
Price quoted for the risk in question	4.9	5
Number of insurers approached for quotes	4.0	4.3
Price range quoted	4.0	4.3
Information on the financial security of the insurer(s)	3.2	3.6
Information on the relative breadth of the coverage offered	4.4	4.7
Commission or other remuneration provided by the insurer(s)	2.6	2.9
Information on the quality of the claims service provided by the insurer	3.3	3.6
Information on the nature and quality of other services provided by the insurer(s)	2.7	3.0
Information on the quality and clarity of documentation provided by the insurer(s)	2.6	2.8
Information on the timeliness of the insurer(s) in inviting renewal	2.4	2.5

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

Figure IX.23
Degree of disclosure of information per country

Member States	Average ranking from 1 (never) to 5 (always) SME	LCC
BE	3	3.9
DE	3.3	3.5
DK	4.1	4.3
EE	3.9	4.1
ES	3.1	3.5
FI	3.8	4
FR	3.3	3.6
HU	3.7	3.9
IT	3.5	3.5
NL	3.4	3.9
PL	3.7	3.8
PT	3.5	3.9
SE	3.9	4.3
UK	3.0	3.2

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

2.8 Other disclosure of information to clients

Art. 12 of the Insurance Mediation Directive imposes extensive information obligations not only on brokers but on all insurance intermediaries. Intermediaries must inform their clients whether they are giving advice on the basis of a 'fair analysis' or whether they are under a contractual obligation to conduct insurance mediation business exclusively with one or more insurance undertakings.

If the insurance intermediary informs the customer that he is giving his advice on the basis of a fair analysis, the intermediary is then obliged to give that advice on the basis of a sufficiently large number of insurance contracts available on the market. In this way the intermediary would be able to make a recommendation, in accordance with professional criteria, regarding which insurance contract would be adequate to meet the customer's needs. An agent, acting on behalf of one or more insurance undertakings, will only be obliged to recommend an insurance contract that is adequate for the client on the basis of the product lines which he is mediating.

On average, our findings show great disparities in the responses received from the various respondents at national level. According to the survey, the average percentage of clients receiving advice on the basis of 'fair analysis' is below 50% in Italy, the UK, France and Portugal. It reaches a percentage of 50% to 75% in Spain and Finland.

At the time of the survey, France and Germany had not yet implemented the Directive. As the sample consisted nearly exclusively of brokers, the seemingly low rates in some of the other Member States appear surprising at first sight. They could be a sign that a number of intermediaries are not yet fully aware of their obligations under the respective provisions transposing the IMD into national law. However, the lower rates could also be explained by the presence of intermediaries in the sample that mediate a high share of large risks, because in this case the information requirements according to the IMD are lower.[118]

For the cases where intermediaries declare to their clients that they are giving advice on the basis of a fair analysis, the survey looked at the number of insurance quotations that form the basis of their advice to clients for the mediation of three distinct policies. Concretely, we asked for the following three examples: 1) a package covering liability and property risks for a company with less than 10 employees, 2) a general liabilities policy of a medium-sized car dealership, and 3) a commercial property risk in the form of an office building with 100 employees. As shown in the table below, responses from brokers confirm that the number of insurance quotations forming the basis of their advice to clients usually increases in accordance with the complexity and costs of the risk to be insured. Regarding the number of quotations submitted there are marked variations between countries. However, some general trends can be observed. Whatever the type of risk considered, in France brokers offer by far the lowest average number of quotations to their clients. We would expect this figure to change with the full implementation of the Directive. In contrast, in the UK followed by Germany and Poland (with a high variation between the lowest and highest figures for the latter) the number of insurance quotations forming the basis of intermediaries' advice to their clients was highest. Belgian brokers also consider a comparatively high number of insurance quotations when advising clients.

Figure IX.24
Intermediaries giving advice on the basis of a fair analysis: number of quotations forming the basis of advice

Proposed policy	Average number	Minimum number	Maximum number
Liability/property: Company with less than 10 employees	3.4	2.2	5.7
General liabilities: Medium-sized car dealership	3.8	2.5	6.2
Commercial property risks: office building w/ +100 employees	4.1	2.8	7.4

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

118 Cf. Article 12(4) of the IMD. It should also be noted that Member States may maintain or adopt stricter provisions regarding these information requirements pursuant to Article 12(5) IMD.

2.9 Assistance with claims

Our survey shows that brokers usually assist their clients with claims. However, there are differences in the assistance provided, depending on the profile of the clients, on the line of products and on the Member State concerned.

In most of the Member States that were part of the survey, brokers offer claims assistance to all SME clients, for whom they have arranged insurance, with the exception of Germany, Sweden and the UK.

Such assistance is offered much less systematically to LCCs. Only in Belgium, Finland, the Netherlands and Portugal are all LCCs offered such assistance.

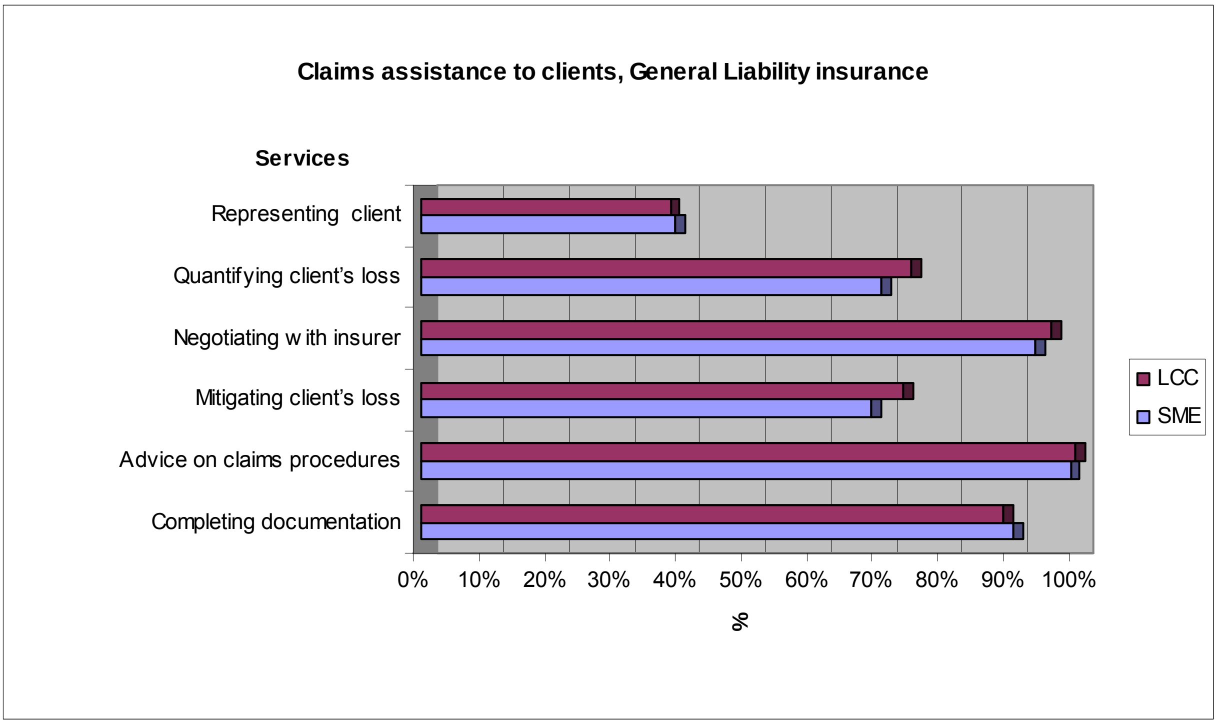
In general the percentage of clients receiving this assistance is quite high, ranging from 88% to 92% for SMEs and 89% to 94% for LCCs, depending on the type of insurance. The lowest figures refer to motor insurance.

According to the respondents, clients are only exceptionally charged separately for this type of service.

Amongst the services that form part of the assistance given to the client in dealing with claims, brokers provide, in order of importance, general advice on procedure, assistance with documentation, assistance in quantifying losses, assistance in mitigating losses, negotiation of liability or the amount of liability and, to a lesser extent, direct or indirect representation of the client in arbitration proceedings or before courts.

Responses to our inquiry show certain differences in the degree of assistance provided to clients according to the clients' profiles as well as variations across Member States.

Figure IX.25



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

3. REMUNERATION OF INTERMEDIARIES

The Commission asked insurance companies to provide detailed information on the remuneration they provide to intermediaries, and insurance intermediaries, mostly brokers and a small number of multiple agents, to explain their sources of revenue.

The questions to 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.

Intermediaries in the 14 Member States selected for this survey[119] were asked to provide information on their revenue from insurance placement, from other services to clients[120] and from services to insurers, as well as specific details of revenue from fees, commissions, contingent/profit commissions and other charges.

The results presented in the following sections exclude data from those 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 might allow conclusions about individual parties' confidential responses to be drawn. However, such Member States have not necessarily been excluded from the textual discussion of the issues concerned. Other methodological issues have been noted below where relevant.

3.1 Composition of intermediaries' revenues

Besides commissions, 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 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, which are discussed in more detail at section 3.4, have been perhaps 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[121] where the amount payable is fixed as a percentage of the premium for the policy placed, including any subsequent additional revenues from the adjustment of premiums following the original placement. The insurance premium paid by the insured party consists, in this case, of the actual price for obtaining coverage of the risk as well as the fee for the mediation services, as both are bundled together.

Contingent commissions

For the purpose of this inquiry we have defined contingent commissions as any kind of payment (excluding client fees and commissions as defined above) paid by insurers to

[119] Please see the explanation on sampling of intermediaries in chapter II of this report.

[120] Please note that in this report, except where indicated otherwise, the term „client" designates a commercial client (i.e. an undertaking in the sense of Article 81 EC Treaty), on whose behalf the intermediary places insurance for a given risk with one or more insurers and/or to whom the intermediary provides any of the separately charged "client services" defined in this report (cf. definitions in the glossary at the annex). Obviously, from the perspective of the intermediary insurers to whom a payable service is rendered would also be considered "clients". The report refers to such services as "services to insurers".

[121] 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 the brokerage commission to the insurer.

intermediaries other than exclusive agents, where the amount payable is based on the achievement of agreed targets relating to the business placed by the intermediary with that insurer[122].

Profit commissions

By profit commissions, we understand 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, and to separately charged services provided to clients. While the activity of some intermediaries consists exclusively of insurance placement, others offer a vast array of separate services. The intermediaries questionnaire defined and solicited information on the following separately charged client services, which were deemed to be the most common and financially most significant ones[123]: claims management, loss assessment, legal services, captive management, risk management, risk control, instalment premium/premium credit, financial planning, and asset management.

It should be noted that in the more recent past there has been a trend towards fee-based remuneration, especially in respect of the large corporate accounts. According to Swiss Re[124], some brokers generate as much as a quarter to a third of their revenues from fees, but on average the share is still low. In a competitive environment, brokers may be asked to rebate some or all of their commission to the client, if all, then in exchange for an agreed fee. For brokers, there may also be some advantages to fee-based remuneration, including the possibility of more stable revenues in times when premium volumes or commission rates are falling.

Revenues from services to insurers

The intermediaries questionnaire solicited information on revenue arising from the following services to insurers, which were deemed to be the most common and financially most significant ones[125]: reinsurance broking, insurance underwriting, loss adjusting, claims management, claims administration, policy administration, accounting services, risk modelling, and risk surveying.

3.2 Relative importance of different sources of revenue

The following figure depicts the reported composition of intermediaries' revenue, for all lines of non-life business insurance placed. Data is presented separately for 11 Member States[126], together with the EU average, which reflects the responses received from all 14

[122] 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".

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

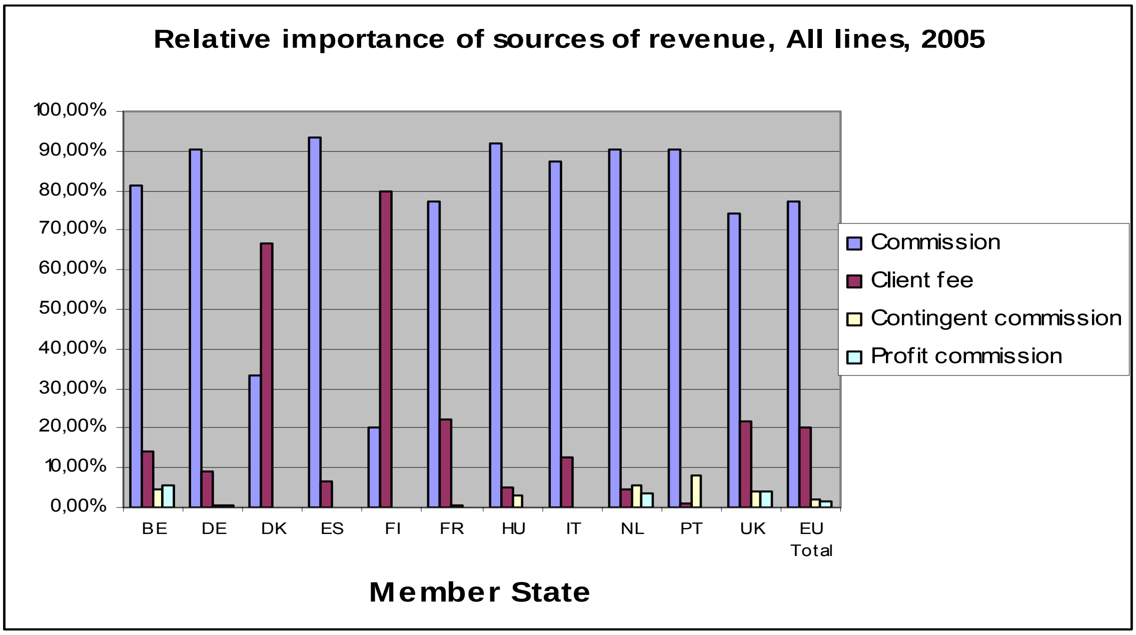
[124] Swiss Re, sigma No. 2/2004, page 26.

[125] Please refer here and elsewhere to the definition of these services in the glossary at the annex.

[126] For the remaining three Member States the number of observations in respect to this question was deemed too low for individual presentation, in accordance with the criteria set out at the beginning of this section.

Member States surveyed[127]. The elements considered are (1) commissions, (2) client fees, (3) contingent commissions including profit commissions, and (4) profit commissions (considered separately). Revenue from services to insurers is excluded.

Figure IX.26



Source: European Commission, Business Insurance Survey 2005-2006

The relative importance is measured in the form of the mean of ratios of the individual sources of revenue across all observations per Member State and across the sample of 14 Member States that are referred to as EU Total. The figures thus reflect the composition of revenue of an average intermediary amongst those included in the sample. The figure shows for the total sample (referred to as EU Total), as well as for the vast majority of individual Member States surveyed, that commissions are by far 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 on the other hand, are more important than commissions in Denmark and Finland, which is explained by the developments in those countries concerning net quoting. 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, when individual responses are looked at, client fees and contingent commissions[128] typically account for a higher percentage of the larger intermediaries' revenue, thus affecting a wider part of the market. Remuneration of broking services on the basis of fees instead of commissions is more common for large corporate clients. This group, however, tends also to use the services of larger intermediaries. Moreover, most of the larger intermediaries offer a full spectrum of specialised services to their clients and generate a larger share of their revenue from separately charged services than do smaller ones. As for contingent commissions including profit commissions, which will be examined in more detail in section 3.4, a number of respondents provided incomplete or incoherent data, claiming weaknesses of information technology or of management accounting systems. Some respondents who discontinued contingent commission agreements in 2005 have not reported revenue from these agreements in 2005, even though

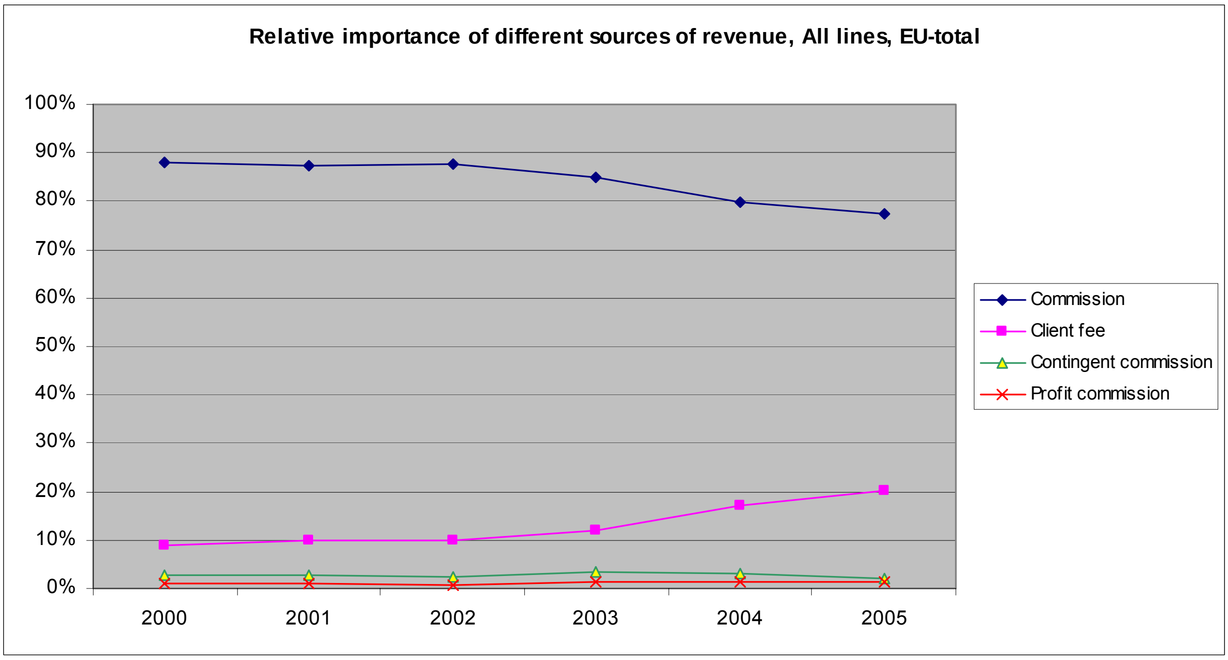
127 Cf. explanation on sampling of intermediaries in chapter II of this report.

128 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.

payments from past agreements may still have been received (and may still be received in the future). Typically, payments are made with a certain time lag, since they are contingent on the achievement of specific underlying targets.[129] The figures given are therefore likely to understate the significance of contingent commissions as a source of revenue.

The following figure provides an overview of the relative importance of sources of revenue for the EU Total from 2000 to 2005.[130] This overview demonstrates a decrease in the relative importance of commissions and the rise in significance of client fees over time. The proportion of contingent commissions and profit commissions has been higher in all years from 2000 to 2004 than stated by respondents for 2005.

Figure IX.27



Source: European Commission, Business Insurance Survey 2005-2006

Besides insurance placement, where the intermediary may return the commission payable 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 services by the intermediary.

The inquiry shows 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 (e.g. in Germany the legal advice act "*Rechtsberatungsgesetz*" restricts the provision of legal advice to certain professions). Moreover, when arranging insurance placement, the provision of certain services may, according to jurisprudence, be part of a broker's fiduciary duties (e.g. in Germany the

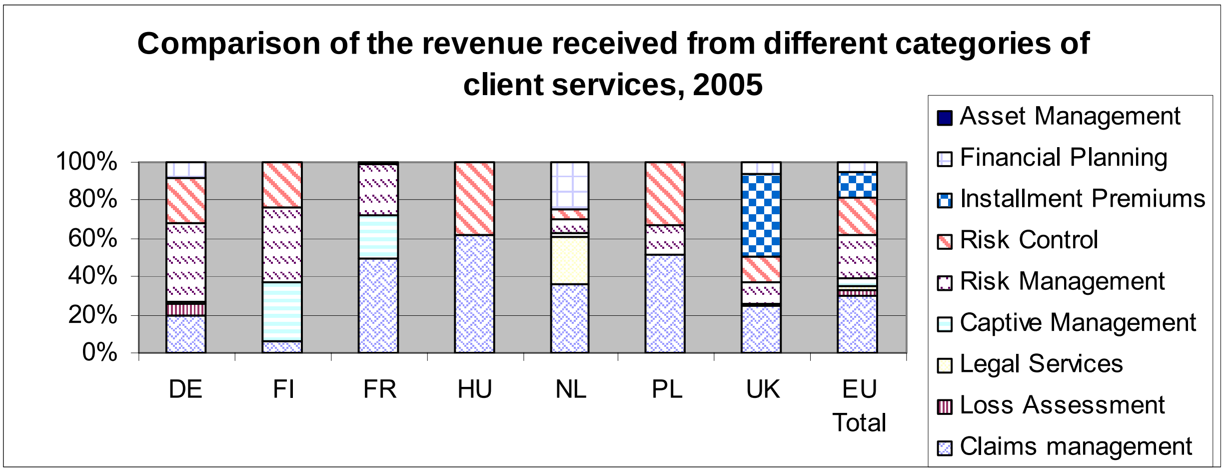
129 Respondents have pointed out that there may be particularly long time lags where profitability targets are concerned.

130 The calculation is based on the same methodological approach as described for Figure IX.27 above.

Bundesgerichtshof's Sachwalterurteil[131]), limiting the scope for separate charging of the services concerned.

Looking at only those intermediaries that did report providing separately charged services to clients, the following figure provides a breakdown of the revenue from different categories of client services in 2005 for selected Member States and the EU Total.

Figure IX.28



Source: European Commission, Business Insurance Survey 2005-2006

Overall, claims management, 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 have a prominent position; in the other Member States no revenue at all has been reported from this service. However, it has to be kept in mind that some of the respondents in the sample may be part of a wider group. In such cases, responses will only include data from respondents and their subsidiaries, but not from other group companies that may provide some of the services listed, for example asset management.

A considerable number of intermediaries surveyed also generate income from the provision of services to insurers. For such services, 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 noted that the way in which intermediaries have structured their activities significantly affects the analysis; for instance, in some cases reinsurance broking has been reported as part of the respondent's activities, whereas in other cases this activity is pursued by another company in the group and the corresponding data has therefore not been provided.

3.3 Commissions

The available data on trends in commission levels is limited as far as the EU is concerned.[132] More information may be available at the level of some of the national markets. For instance, German brokers have pointed out 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

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

[132] 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, page 26.

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 of other factors[133].

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 the extent to which competition on the price of the mediation service itself is possible. This price is agreed between the insurer and the intermediary[134], 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 as 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,[135] 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, however, commission rebating is still legally prohibited.[136]

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 commissions. The figure below depicts the percentage of clients to whom the intermediaries surveyed spontaneously disclose the commission earned on the insurance business arranged and to which percentage of clients they disclose their commission at the request of the client.

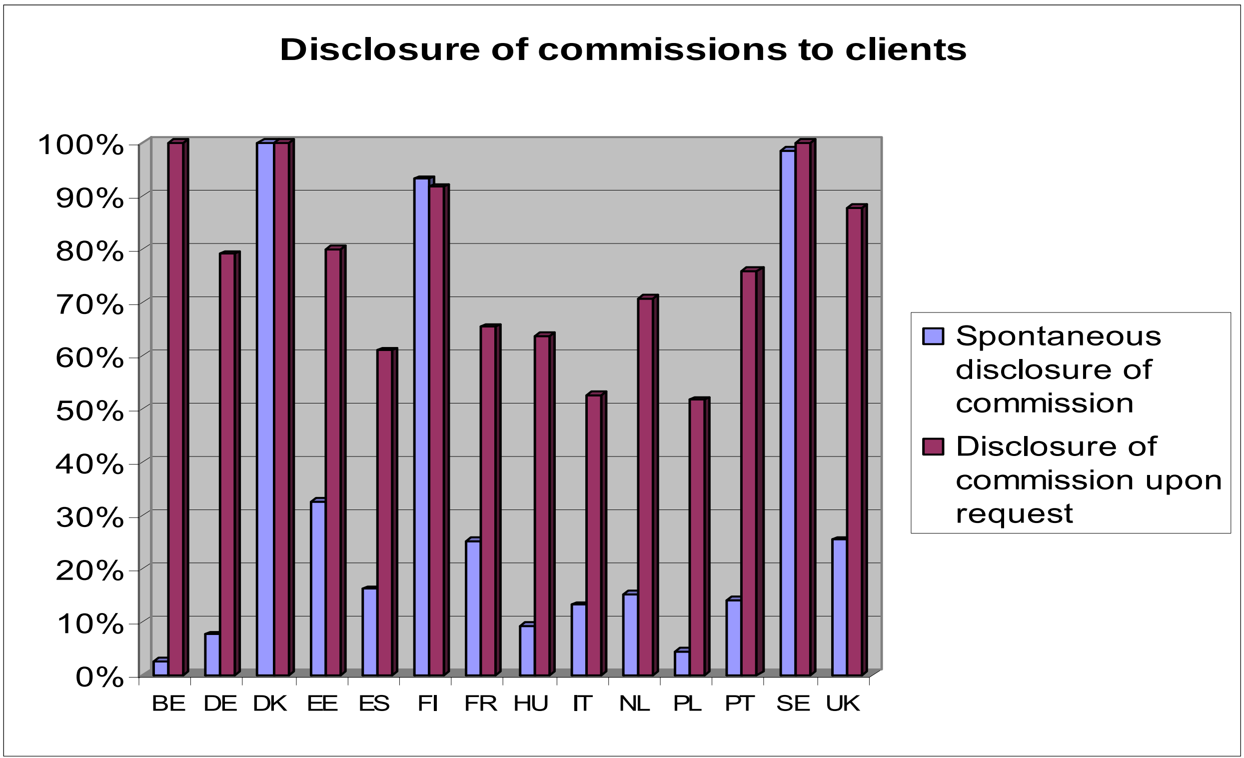
133 Including, for instance, an insurer's business policy according to which commission rates agreed with intermediaries may be used to promote the sale of certain products that may be more profitable than others.

134 Obviously, this does not refer to net-quoted business.

135 The questionnaires did not specifically address the issue of commission rebating. Information received in relation to this matter may, therefore, not be representative and needs to be confirmed prior to drawing final conclusions.

136 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.

Figure IX.29



Source: European Commission, Business Insurance Survey 2005-2006

The figure shows a high rate of spontaneous disclosure of commissions only for Denmark, Sweden and Finland, explained by the recent developments in these countries concerning the introduction of net-quoting. The relatively higher rate in Estonia than in the remaining Member States may be explained by the presence of certain large brokers in the limited sample for this country.[137] For the other Member States the rates of spontaneous disclosure range from roughly 3% in Belgium to 25% in France and in the UK.

The figure concerning the disclosure of commission upon clients' request is higher in all Member States. However, a considerable number of clients – reaching up to nearly 50% in Italy and Poland – would not be given information about commissions, even if they specifically requested this information. It should be noted that these figures have been provided by intermediaries themselves; there may be some doubts as to the reliability of the figures, since a number of respondents have claimed that their clients never request this kind of information, but that they would – hypothetically – provide the information if asked. Moreover, in addition to commissions intermediaries may earn other forms of 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 a major problem.[138] This issue is highlighted in section 3.4 below.

As far as competition on the price of the mediation services is concerned, it should be noted that the sector inquiry has not collected specific information on commission rebating, but the issue may be of interest in the follow-up of this interim report. The prohibition of commission rebating by insurers could amount to resale price maintenance and, as such, would

[137] Some of these larger brokers have implemented business reforms also for their European subsidiaries subsequent to the Spitzer investigation in the United States.

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

not benefit from the block exemption granted by the Regulation on vertical agreements and concerted practices.[139]

3.4 Contingent Commissions including Profit Commissions

3.4.1 Background

Contingent commissions have been in the spotlight following investigations carried out in the United States of America, in particular by the office of Eliot Spitzer, at the time New York State Attorney General[140]. 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 the large brokerage firm 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."*[141]

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 commissions 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.*"[142]

Settlements were agreed with the parties that were subject of the complaints leading to the adoption of far reaching business reforms. Among other things, the brokers concerned 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.[143] The

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139 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.

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

141 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.

142 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.

143 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.

commitments made in these settlements in the United States are, however, subject to a limitation on extraterritorial effect.[144]

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 that date and would take effect in the future. The elements to be provided included details of (i) the intermediaries concerned, the dates of the agreement and their period of 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 each intermediary 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 without underwriting authority[145]. Moreover, insurers had to indicate (in percentage 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 those requested from insurers (cf. above). Intermediaries were also asked for a breakdown of the various sources of their revenue. Furthermore, they had 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 such as, for instance, means or medians.

3.4.3 Empirical findings and interpretation of data

In this section we provide an indication of how wide spread 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

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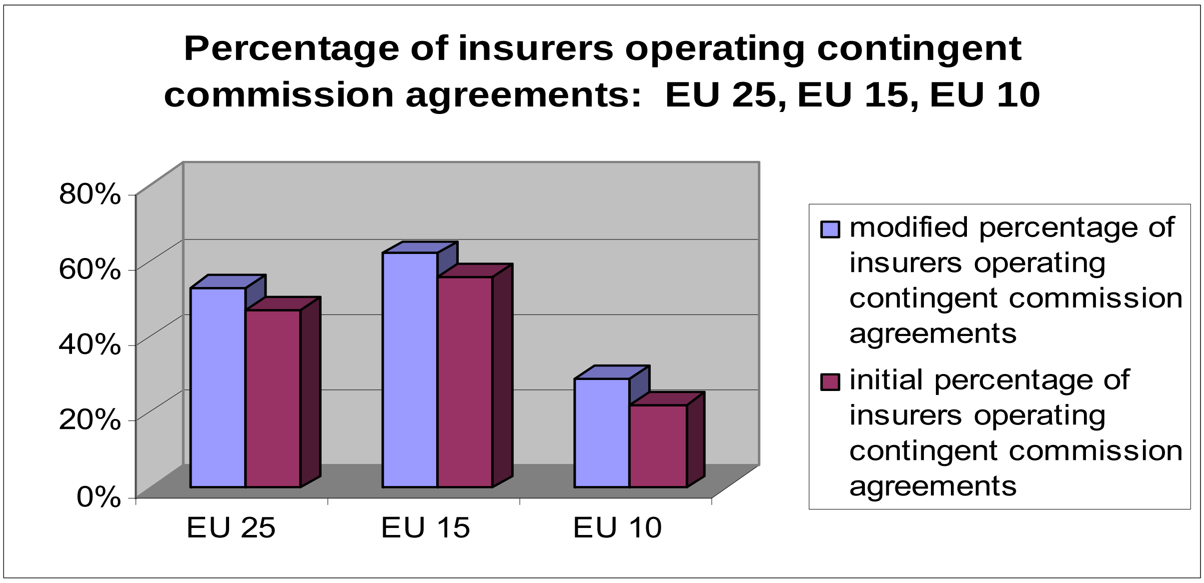
[144] The relevant provisions apply to entities that service clients in the United States, place, renew, consult on or provide services for policies covering risks in the United States or are, themselves, domiciled in the United States.

[145] 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.

actual values, as some insurers and intermediaries have not provided the entire set of data requested. This was sometimes blamed on 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 they did not consider the agreements to be contingent commission agreements (sometimes it was stated in a more nuanced way that the agreements were not comparable to the contingent commission agreements which were the subject of the Spitzer complaint). The analysis of the copies of the agreements provided and of the further explanations given 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 provided in the response.

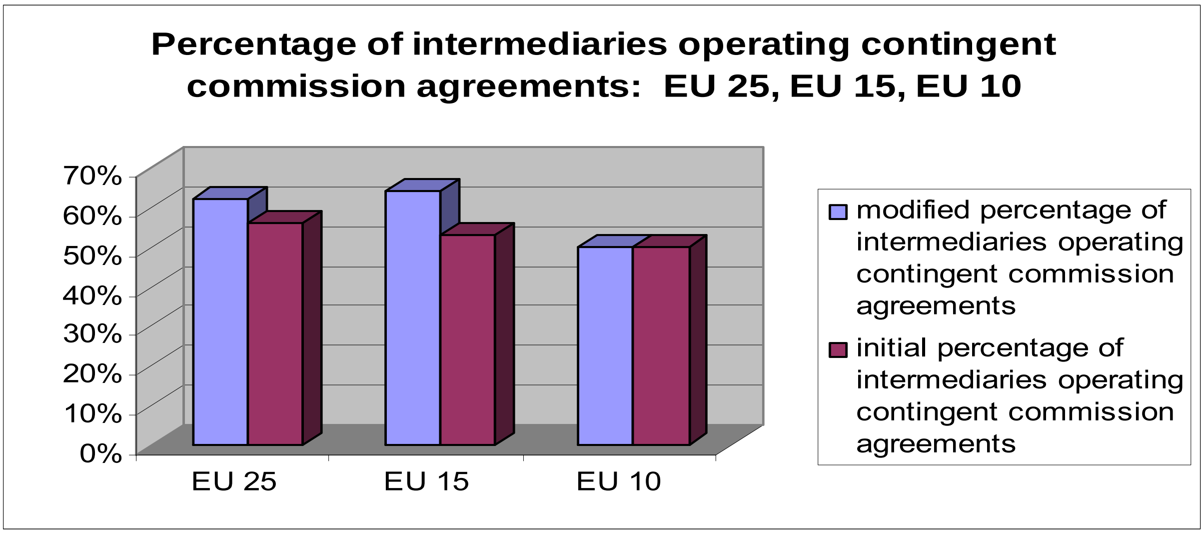
The following figures show the percentage of respondents that confirmed having operated contingent commission agreements at any point in time between 2003 and 2006, irrespective of the number of agreements operated and of whether or not such agreements were abandoned subsequent to the investigation of Mr Spitzer. Additional elements highlighting the significance of contingent commissions and the effect of the Spitzer investigation are provided below.

Figure IX.30



Source: European Commission, Business Insurance Survey 2005-2006

Figure IX.31



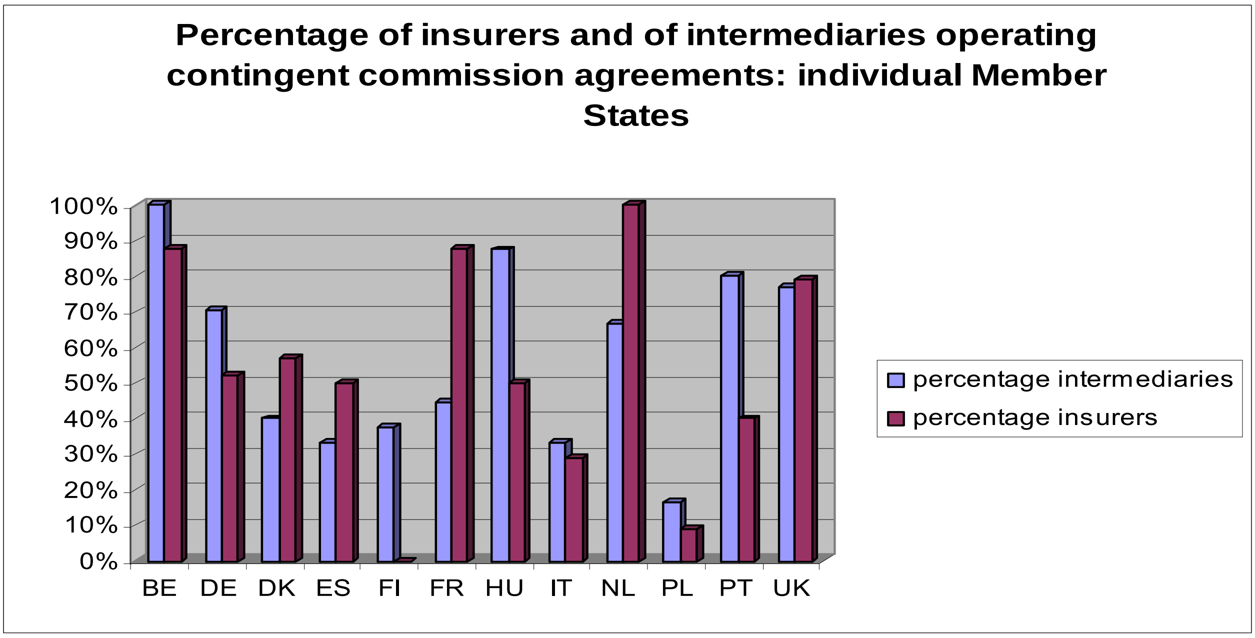
Source: European Commission, Business Insurance Survey 2005-2006

The columns entitled "initial percentage" reflect the percentage of affirmative responses out of all responses received from insurers or intermediaries; the columns "modified percentage" include those responses where the relevant table had not been filled in by respondents, but where other information provided by them proved the existence of contingent commission agreements. The figure shows that more than 50% of all insurers in the sample covering the 25 Member States of the European Union (EU-25) operated contingent commission agreements in the period 2003-2006. The corresponding figure is much lower for the 10 Member States that joined the EU in 2004 (EU-10) and higher for the 15 others (EU-15).

The sample of intermediaries consisted of 14 Member States, of which 11 are part of the EU-15 and three of the EU-10. For this sample the figure shows that nearly 60% of intermediaries operated contingent commission agreements in the EU-25, with a slightly higher value in the EU-15 and a lower value in the EU-10.

The figures, which provide an unweighted snapshot of all responses received, should be considered in conjunction with the further elements set out below. As explained in chapter II, due to the sampling technique applied, large insurers and intermediaries have a fairly high representation in the sample and relatively more so in the smaller Member States where the total sample size was more limited. Similarly, the small Member States tend to be over-represented in the sample in terms of the share of these markets of all insurance sold and serviced in the EU. Insurers that sell their products only through direct sales and exclusive agents do not, by definition, operate contingent commission agreements. The extent to which such companies are represented in the sample does therefore have an impact on the percentages calculated for the overview. As only three Member States of the EU-10 were part of the intermediaries' sample, the corresponding figure calculated for intermediaries in the EU-10 should be considered with a certain caution. The presentation broken down by Member State below highlights the high prevalence of contingent commission agreements in the Hungarian sample of intermediaries. Hungary, however, is over-represented in the total sample vis-à-vis Poland.

Figure IX.32



Source: European Commission, Business Insurance Survey 2005-2006

Figure IX. 32 shows the percentage of respondents which operated contingent commission agreements at any point in time during the period 2003-2006 in 12 out of the 14 Member States where both insurers and intermediaries were surveyed[146]. The following observations can be made.

The insurers' survey points 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 have indicated that they operated such agreements in the period under consideration. To a lesser, but still considerable, extent, insurers in Portugal and in Italy also reported contingent commission agreements, whereas the corresponding figure for Poland is much lower.

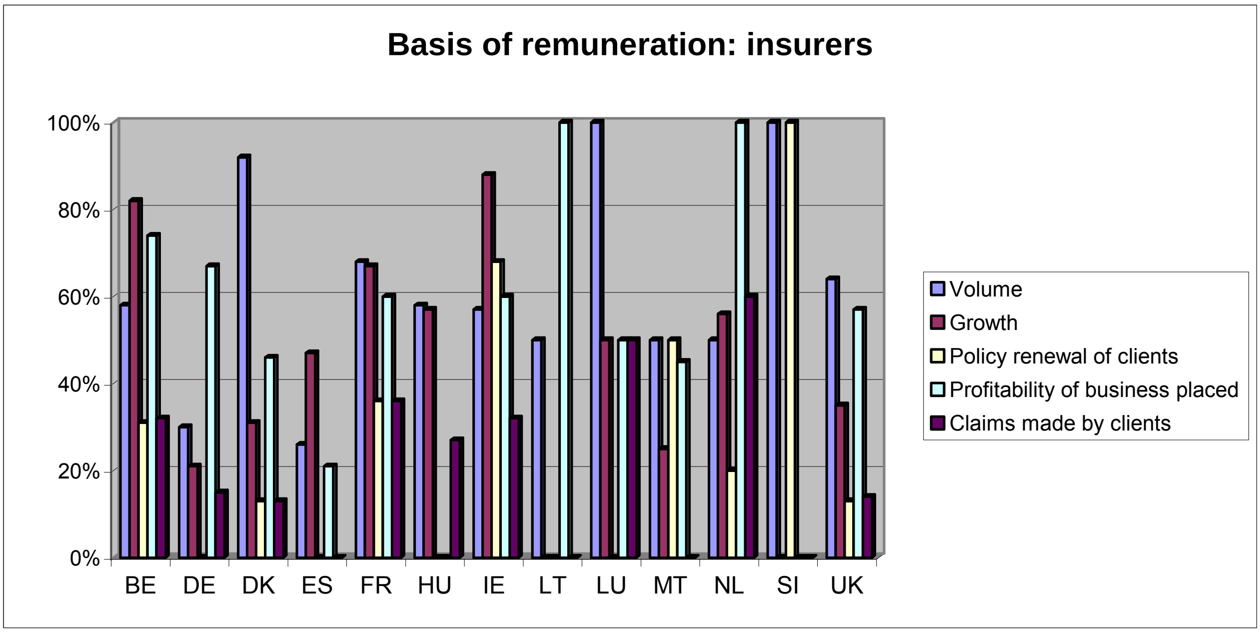
Obviously, the responses from intermediaries cannot be directly compared to the insurers' responses, as the fact of whether or not a company has concluded contingent commission agreements may depend on company-specific factors, such as its business policy (for insurers, notably including its choice of distribution channels). The intermediaries' responses do, however, largely confirm the pattern observed in the insurers' survey.

As far as those Member States are concerned where only insurers were surveyed, in some cases the number of reliable observations or the quality of data submitted was too limited to allow for final conclusions. Under the reserve that the responses submitted are correct, it would appear, however, that contingent commissions may have played a fairly limited role in most of the EU-10. In Austria, the majority of respondents stated that additional commissions were paid contingent on the achievement of growth targets relating to the book of business with an intermediary or on profitability criteria. Most respondents did not, however, submit the full set of data requested, arguing that such agreements were a traditional form of remuneration and alleging that their agreements were different from the ones which formed the focus of the Spitzer investigation.

[146] For the remaining two Member States the number of observations in respect to this question was deemed too low for individual presentation, in accordance with the criteria set out at the beginning of this section.

The following two figures provide an overview of responses concerning the criteria used in contingent commission agreements. 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 asked to indicate the basis of remuneration for each of the agreements in effect at any point in time during the period of 2003-2006.

Figure IX.33

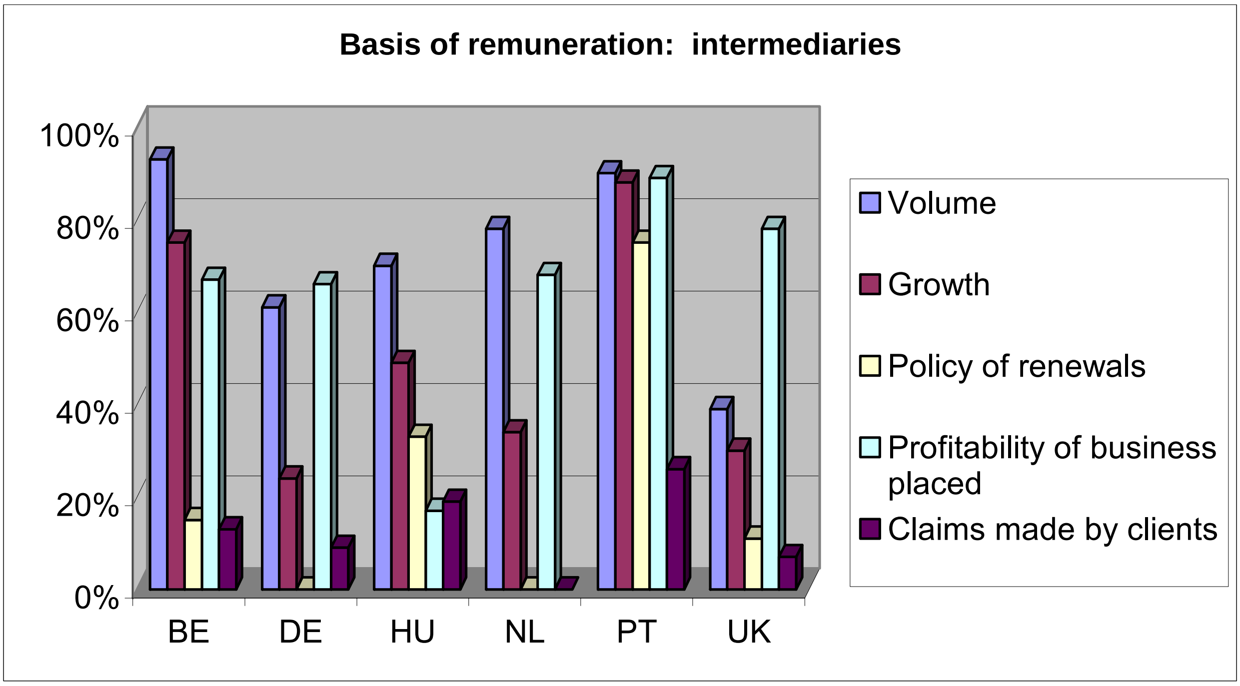


Source: European Commission, Business Insurance Survey 2005-2006

We first look at insurers in 13 Member States, presented in accordance with the criteria set out at the beginning of this section. In nearly all of these Member States the percentages indicated for the different parameters add up to more than 100%. This reflects the fact that apparently most contingent commission agreements have stipulated the achievement of more than one target at a time. As can be seen, volume, growth and profitability targets are most important. 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, depicted in the figure below, confirms this observation for the Member States selected.

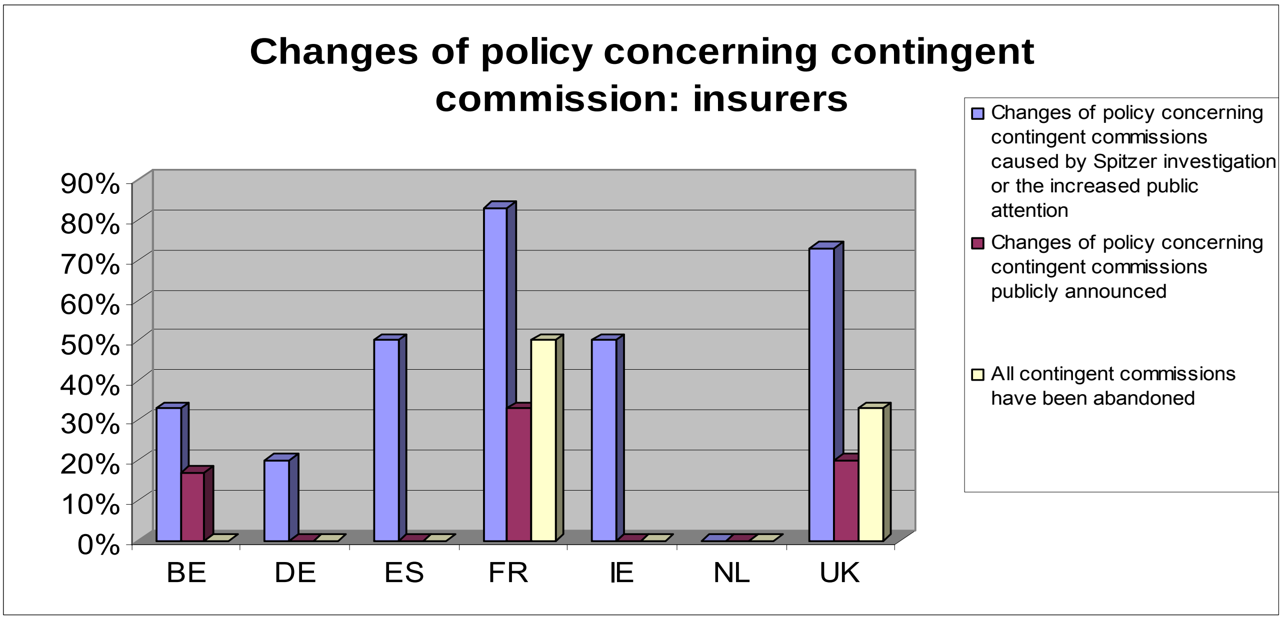
Figure IX.34



Source: European Commission, Business Insurance Survey 2005-2006

The Commission also asked about the effect of the Spitzer investigation and the increased public attention on respondents' policy concerning contingent commissions.

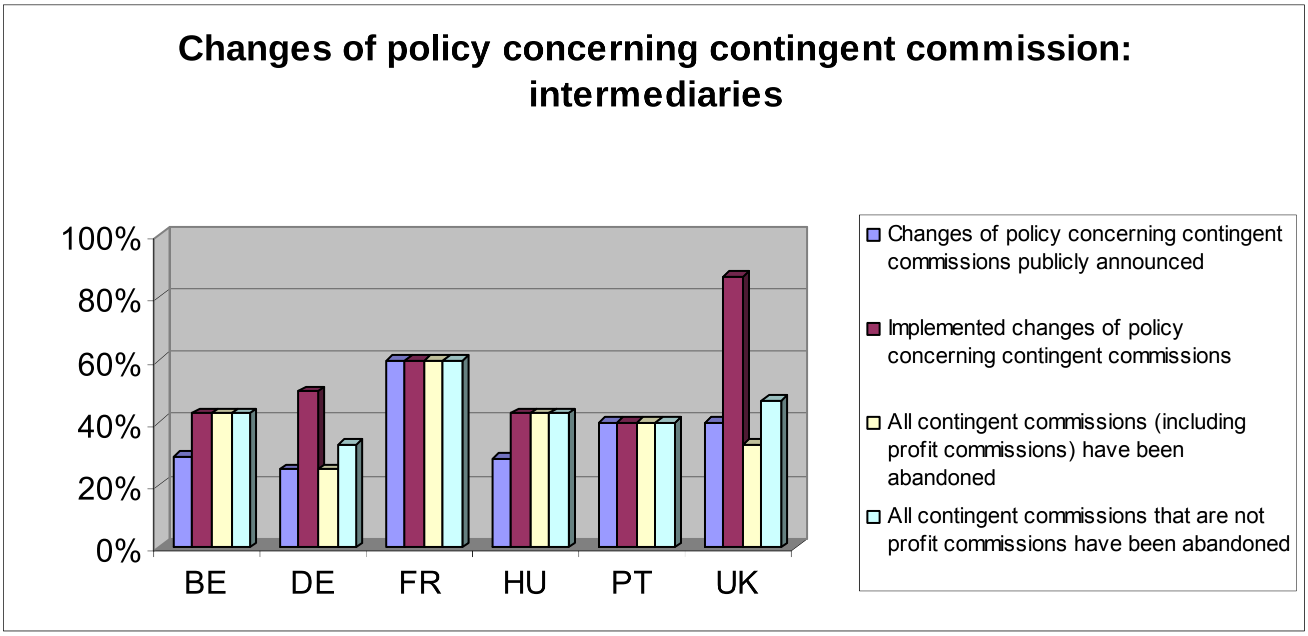
Figure IX.35



Source: European Commission, Business Insurance Survey 2005-2006

The figure above shows changes in insurers' policy concerning contingent commissions for the selected countries. In Belgium, Germany, Spain and Ireland between 20% and 50% of respondents 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 respectively 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 potentially opportunistic behaviour. Obvious conflicts of interest arise where intermediaries provide underwriting services to insurers in respect of the intermediaries' own insurance placement clients. In the past there have been attempts to avoid such conflicts of interest by creating hybrid underwriting facilities that feature staff employed by the insurer embedded in the facility operated by the intermediary.

Figure IX.36

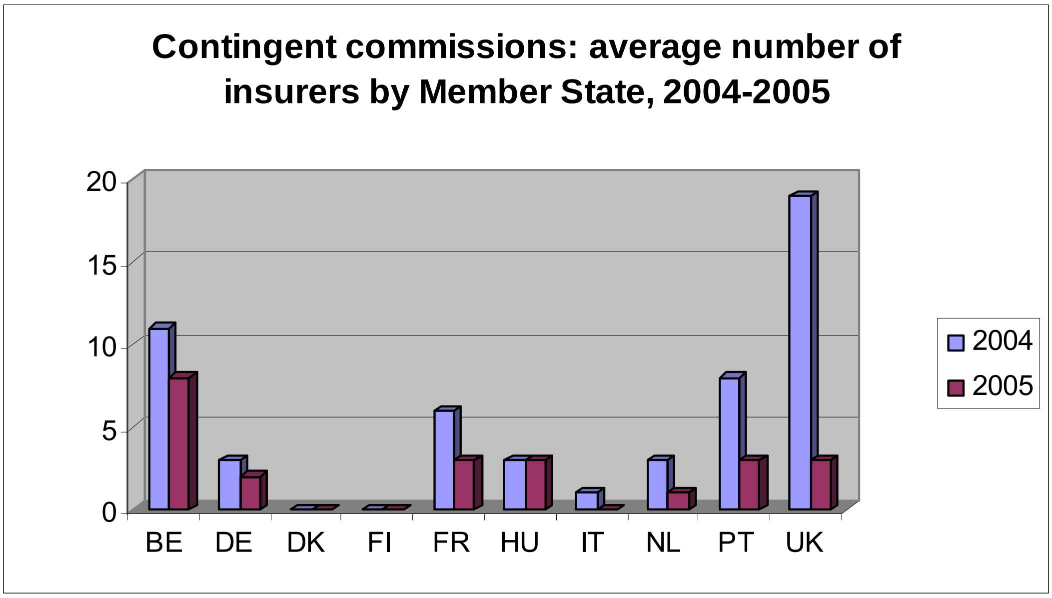


Source: European Commission, Business Insurance Survey 2005-2006

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 figures are 50% for Germany, France 60%, and in the UK more than 80%. However, in the UK and in Germany less than half of the respondents who reported changes in their policy had abandoned all contingent commissions (including profit commissions).

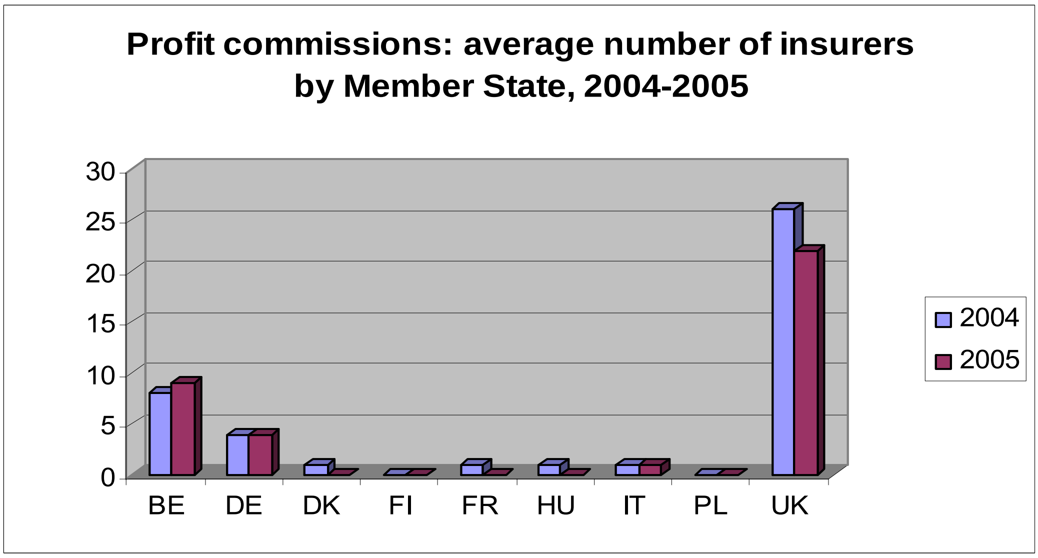
The following two figures show the average number of insurers with whom intermediaries had contingent commission agreements (without profit commission agreements), and, separately profit commission agreements in the years 2004 and 2005. It should be noted that some respondents stated that they were not able to distinguish between profit and other contingent commissions, in which case the responses were included in contingent 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.

Figure IX.37



Source: European Commission, Business Insurance Survey 2005-2006

Figure IX.38

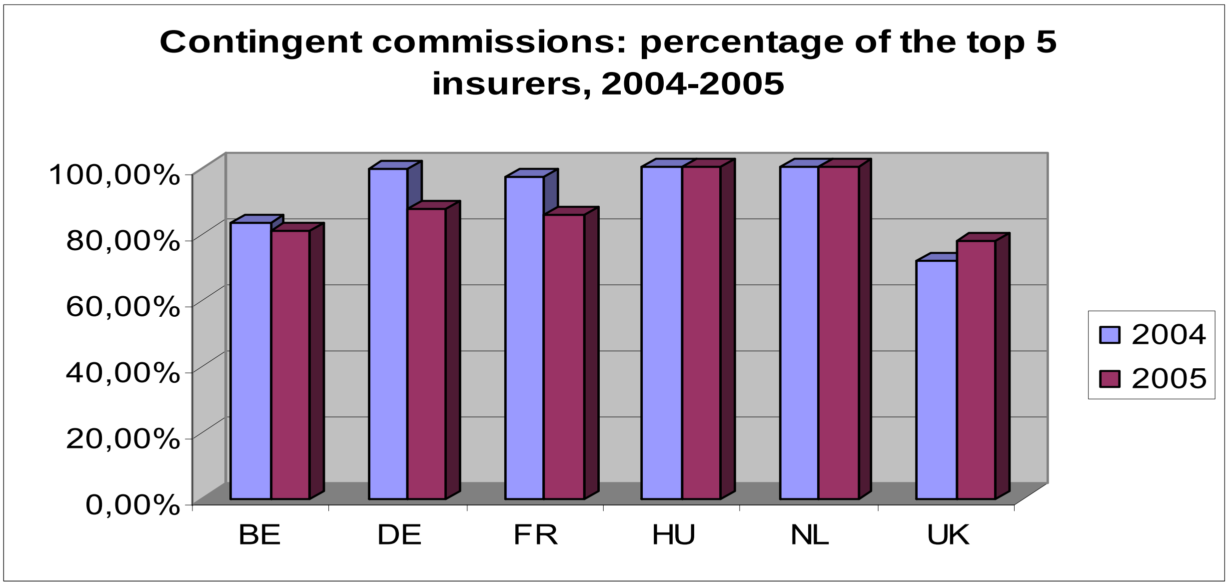


Source: European Commission, Business Insurance Survey 2005-2006

In particular in relation to contingent commissions that are not profit commissions there is 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 is clearest in the UK. To a large extent the drop in the average number reflects the fact that some major brokers that had agreements with a large number of insurers abandoned all or most of their contingent commission agreements.

The figure below shows the accumulated average percentage of revenue from contingent commissions (without profit commissions) that intermediaries surveyed received from the five insurers that were most important for each broker for this sort of revenue for selected Member States.

Figure IX.39



Source: European Commission, Business Insurance Survey 2005-2006

In all cases, the top five insurers account for the vast majority of intermediaries' revenue from this source, 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 the potential for conflicts of interest that arises when intermediaries place business on behalf of their clients.

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 of which insurers claim that they are not directly related to the achievement of agreed targets (and that would thus not constitute contingent commissions covered by the definition used in this report).

This concerns, for instance, 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 labelled somewhat euphemistically by respondents and have not been included in responses, thus leading to an understatement of the figures reported. In this context we refer to the findings of the Spitzer investigation that agreements to pay contingent commissions were "*… styled as payments for nebulous* *services"*[147] and *"… that brokers routinely mislead their clients about the true nature of contingent commissions*"[148].

Irrespective of the formal qualification 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 give rise to a conflict of interest on the part of the intermediary and create incentives to steer business to a particular insurer, even where not formally contingent on the achievement of any agreed targets. However, the data obtained so far in the framework of the sector inquiry do not allow for any concrete conclusions as to how widely spread and financially significant payments of this sort are in reality.

3.5 Conclusions

Based on desk research and data supplied by insurers, brokers and a small number of multiple agents, this chapter has analysed a number of issues linked to the structure of distribution channels, the role of intermediaries as well as the remuneration of those intermediaries which are not constrained by agreement to refer business to one insurer.

The structure of the various distribution channels varies between Member States; the business insurance market in the EU is predominantly served by brokers. Exclusive agents constitute the second most frequently used channel across the EU for most insurance lines.

Certain distribution structures can, under specific circumstances, act as market entry barriers. Conversely, the existence of a broker channel can facilitate market entry for foreign insurers that do not have their own or a sufficiently developed distribution network.

Brokers can generally place insurance with a large number of insurers. However, it appears that in many cases their business is concentrated on a small number of insurers.

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 conflicts of interest between the objectivity of the advice they provide to their clients and their own commercial incentives.

Conflicts of interest that could jeopardise the role of brokers and multiple agents in stimulating competition in the insurance marketplace can arise from a number of sources linked to their remuneration, including contingent commissions and fees for 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.

A lack of transparency in intermediaries' remuneration reduces the potential for price competition in relation to mediation services, which in the case of commissions are bundled with the provision of insurance cover.

The survey has not established to which extent commissions are rebated to clients. A 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. The Commission intends to further examine this issue in additional fact-finding.

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[147] 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.

[148] 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.

X. HORIZONTAL COOPERATION

1. INTRODUCTION

Cooperation among companies is significant in the insurance sector. In order to spread risks, insurers cooperate in pooling arrangements[149]. They also cooperate in producing reliable statistics on the frequency and size of claims, which are necessary for risk rating. Moreover, they cooperate in the preparation of standard policy conditions, in the definition of standards for security equipment as well as in the settlement of claims concerning policyholders who are clients of different insurance companies.

Some forms of cooperation are at present block exempted by the Commission which, in the aftermath of the *Verband der Sachversicherer* judgement[150], adopted Regulation 3932/92[151]. The Regulation entered into force on 1 April 1993 and was valid for ten years, until the end of March 2003. It was then replaced by Commission Regulation (EC) 358/2003[152] which was adopted on 27 February 2003. The new Regulation, whose contents are very similar to those of the previous one, block-exempted 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 safety devices[153].

The new Regulation is valid for seven years and will thus expire on 31 March 2010.

During the Sector Inquiry, the Commission collected, from insurance companies as well as from insurers' associations[154], data concerning the level of cooperation in the industry. These

[149] In order to spread risks, insurers also cooperate vertically in reinsurance arrangements.

[150] See judgement of 27 January 1987 in case 45/85, *Verband der Sachversicherer e.V. v Commission* [1987] ECR 405, p. 449-452. In this judgement, the Court rejected the arguments that unlimited competition would increase the risk of insolvency to the detriment of consumers – the so called "destructive competition" argument - and that, as cooperation between insurers was required to avoid such a risk, special rules should be adopted under Article 83 EC to limit the applicability of Articles 81 and 82 EC. It thus stated that Articles 81 and 82 EC apply without restriction to the insurance industry. The Court also noted that it was for the Commission, when granting exemptions under Article 81(3) EC, "to take account of the particular nature of different branches of the economy and the problems peculiar to them".

[151] Commission Regulation (EEC) 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. The Commission adopted this Regulation after having being empowered to do so by Council Regulation (EEC) 1534/91 of 31 May 1991 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 143, 7.6.1991, p. 1.

[152] Commission Regulation (EC) 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.

[153] Council Regulation (EEC) 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.

[154] See Chapter II, sub-sections 2.2.1 and 2.2.2 for information on the methodology followed for the survey.

data show that the level of cooperation varies significantly among the various insurance lines and from one Member State to another.

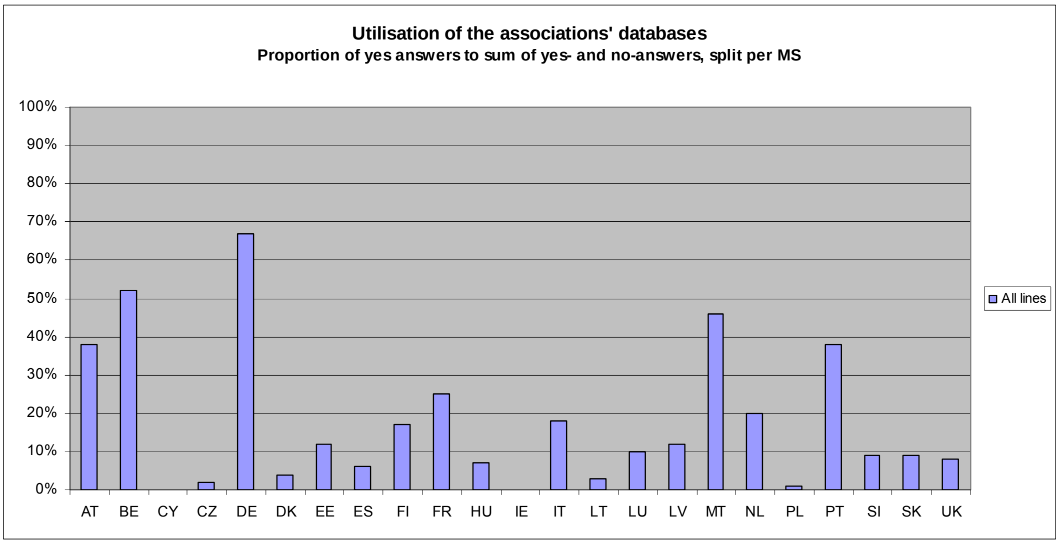
2. COOPERATION IN THE CALCULATION OF THE AVERAGE COST OF RISK AND ON STUDIES

As for cooperation among insurance companies, or within associations of insurance companies, in the calculation of the average cost of covering a specified risk in the past, fourteen of the twenty-three insurers' associations which replied to the survey conducted in 2006, have stated that they are involved in the joint establishment and distribution of calculations, in particular as far as Motor, Property and General Liability insurance lines are concerned.

The data derived from the insurance companies' replies to the Sector Inquiry confirm that the level of cooperation in this field varies significantly among Member States and across insurance lines.

Figure X.1 below shows that respectively 67 % of the German, approximately 50 % of the Belgian and the Maltese and approximately 40 % of the Austrian and the Portuguese respondents use data obtained from their association to assist them in the calculation of the risk premium[155]. According to the combined analysis of data collected from both the insurers' associations and the insurance companies, this cooperation seems much less important in Member States such as Hungary, Denmark and Poland.

Figure X.1



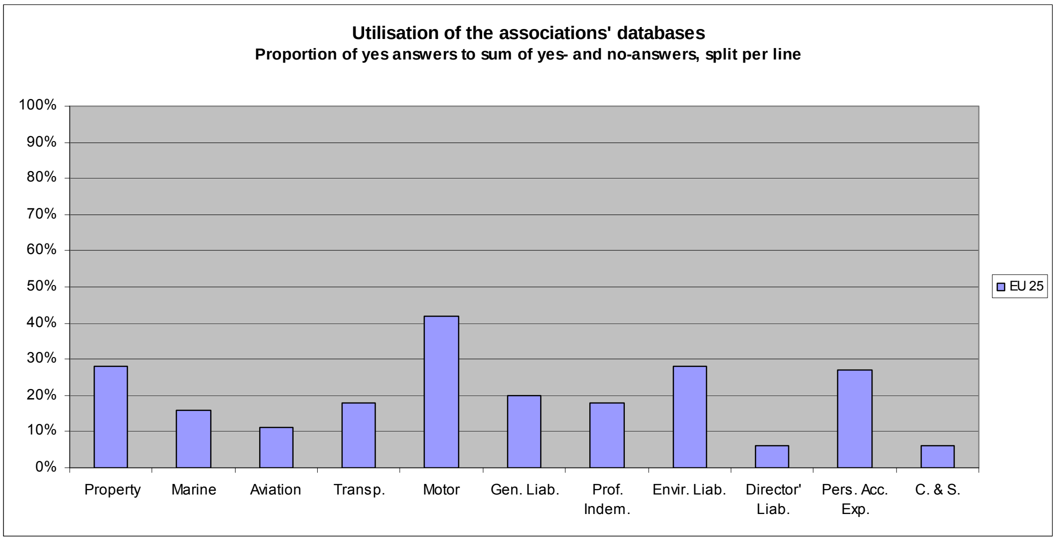
Source: European Commission, Business Insurance Survey 2005-2006

Figure X.2 below presents the breakdown by line of insurance. This data shows that cooperation is significant as far as the Motor insurance line is concerned, with 42 % of the respondents stating that they calculate risk premiums on the basis of data obtained from their association. Cooperation is also important for the Property/Business Interruption, the Environmental Liabilities, the Personal Accident/Medical Expenses and the General Liability insurance lines. However, as far as the Directors' and Officers' Liability and the Credit

[155] This figure does not include data concerning the replies of Greek and Swedish insurance companies as these data are of limited statistical relevance. This is due to the low number of observations related to this specific question.

and Suretyship insurance lines are concerned, only 6 % of the respondents seem to make use of such cooperation.

Figure X.2



Source: European Commission, Business Insurance Survey 2005-2006

The full set of data[156] concerning the use of associations databases by insurance companies broken down by Member State and by insurance line reveals that in Germany, in particular, this cooperation is substantial for the Property/Business Interruption, the Motor, the General Liability, the Environmental Liabilities and the Personal Accident/Medical Expenses insurance lines with utilisation rates scoring between 80 and 100 %. Such cooperation is also significant for the Professional Indemnity/E&O, the Transportation and the Marine insurance lines, with utilisation rates between 45 and 65 %. In Belgium, the highest utilisation rates concern Property/Business Interruption and Personal Accident/Medical Expenses (both at 63 %); much lower utilisation rates are reported for the General Liability and the Directors' and Officers' Liability insurance lines (respectively, 25 and 20 %). In Austria, the utilisation rate is respectively 50 % for the Property/Business Interruption and the General Liability insurance lines and 40 % for the Motor insurance line. On the other end, in Hungary, Denmark and Poland, the utilisation rates are very close to zero or they equal zero for all insurance lines, with only a few exceptions (General Liability and Property/Business Interruption, in Hungary, Personal Accident/Medical Expenses, in Denmark, and Motor, in Poland, where however the utilisation rates are between 10 and 20 %).

As for the utilisation of databases from associations of which insurers are not members, it is worth noting that, although the data on this issue are of limited statistical relevance[157], they seem to indicate that this form of cooperation among insurers is insignificant[158] for practically all Member States and all lines.

Some associations have stated in their replies to the survey that they do not always make calculations and studies available to non-member insurance companies. One association has replied that calculation and studies are available only for insurance companies that have

[156] This full set of data is not shown in a table or a figure as, due to the amount of information to be presented, the table or figure would not be user-friendly.

[157] This is due to the low number of observations related to this specific question.

[158] Utilisation rates very seldom exceed 5 % and are most frequently between 0 % and 2 %.

participated[159] in the calculations and in the studies. Another association has indicated that only full members taking part in a "statistical initiative are entitled to receive the detailed results (although consolidated) of the studies" whilst the "generic results of statistical studies are usually available to the public". Finally, two associations have stated that non-members do not have access to their calculations and studies.

The question concerning the conditions under which associations make calculations and studies available respectively to members and non-members will be treated below, in section 7 of the present chapter.

3. STANDARD POLICY CONDITIONS

According to the results of the Sector Inquiry, cooperation concerning the joint establishment and distribution of standard policy conditions for direct insurance seems *prima facie* substantial. However, differences exist among Member States and among insurance lines.

Out of the twenty-three insurers' associations that replied to the survey conducted in 2006, only three stated that they were not involved in the joint establishment and distribution of standard policy conditions. The twenty associations that replied positively to the question are involved in the establishment of standard policy conditions for practically all insurance lines, and in particular the Property/Business interruption and the General Liabilities lines.

The cooperation seems however insignificant in the Czech Republic and in Poland, and marginal in Spain, Greece and Ireland.

While the majority of the respondents indicated that they make their standard policy conditions expressly non-binding on their members or any other insurance companies having access to them and that they do not recommend their utilisation, four associations stated that they do recommend their standard policy conditions and one indicated that in some cases, if the insurer freely decides to use the standard policy condition, for reasons of clarity and understanding, the association recommends to keep its wording unchanged. One association replied that its standard policy conditions are binding.

Moreover, in the context of the survey conducted in 2006, one association said that its standard policy conditions were not accessible to any interested party and another indicated that its standard policy conditions were available only to its members.

Finally, it should be mentioned that the Sector Inquiry also focussed its attention on cooperation on the drafting of a particular type of standard policy conditions, i.e. premium indexation clauses.

These clauses stipulate a premium adjustment, related to the application of a certain index, in case of contracts concluded for more than one year or in case of extension or renewal of an existing contract. Premium indexation may relate to a price index, to the adjustment of the insured value, to the development of claims or to any other reference parameter.

Replies from insurers to the Sector Inquiry indicate that 28 % of the respondents use premium indexation clauses. This average figure however hides the fact that the use of such clauses differs widely between the various insurance lines and from one Member State to another.

The utilisation rate reaches 67 % in the Property/Business interruption insurance line, ranges between 30 and 40% for Motor, General Liabilities, Personal Accident/Medical Expenses and goes down to 8% for the Directors' and Officers' Liability and for the Transport insurance lines.

[159] We interpret the term "participation" as referring to the provision of statistical data and other information.

Table X.1 below shows the variation of the utilisation rate for selected lines and Member States[160].

Table X.1

Countries	TOT	PROP	TRANSP	MOT	GEN.LIAB.	D&Os	PERS.ACC.
AT	38	100	0	100	33		50
BE	32	86		0	13	0	88
DE	48	89	0	71	95		16
DK	74	100	0	100	100		100
FR	36	100	14	0	38	17	50
IT	29	71	7	21	64	8	71
NL	26	100	0	20	20		20
PL	12	30	10	10	22	0	0
PT	22	83	0	67	17	0	50
UK	15	61	0	12	9	0	6

Source: European Commission, Business Insurance Survey 2005-2006

It seems that insurers mainly use premium indexation clauses that they have developed themselves (the utilisation rate of such clauses is 58 %). Just under half of the respondents (46 %) indicated, however, that they use premium indexation clauses developed by insurers' associations, affiliated committees or working groups or other industry bodies. Table X.2 below groups Member States according to the utilisation rate either of clauses developed by the insurer himself, or of clauses developed by an insurers' association or of clauses of other origin.

Table X.2

% range	Own	Insurance Ass.	Others
95/100	LT LU		
75/94	AT FI	BE DE FR PT	
50/74	BE FR NL UK	DK HU NL	
25/49	DK HU	AT FI	LU FR HU
5/24	DE PT	UK	AT BE DE NL UK
0/4		LT LU	DK FI LT PT

Source: European Commission, Business Insurance Survey 2005-2006

As for premium indexation clauses developed by insurers' associations, the data collected from the associations show that only half a dozen of them have developed premium indexation clauses. Table X.3 below shows the number of these clauses, broken down by line and by type of index, referring either to a price, to the adjustment of the insured value, to the development of claims or to any other parameter.

[160] Data presented in the table are those which are of statistical relevance due to the high number of observations. Conversely, some cells in the table remain empty because the data at stake was not statistically relevant, due to a low number of observations.

Table X.3

	Price Index	Index related to insured value adjustment	Index related to claims development	Index related to other parameter
Prop./Bus. Int.	1	14		8
Aviation			4	
Motor	1	1	2	
Gen. Liab.		2	1	1
Env. Liab.			1	
Pers. Accid.		2		

Source: European Commission, Business Insurance Survey 2005-2006

4. CO-INSURANCE POOLS

As for co-insurance pools, data collected from insurance companies show that pools covering the territory of a single Member State are common for Property risks, as well as for General Liability, Motor and Professional Indemnity risks. Certain pools provide cover for different risks at the same time. This form of cooperation is particularly significant in Germany, the Netherlands, Belgium, Finland and the UK. It seems less frequent in Italy, the Baltic Member States, Hungary, Slovenia and Poland.

The replies of insurers' associations to the survey show that, since 1993, associations have been only moderately involved in pools. Out of 23 associations, 14 stated that they had not been involved, either directly or indirectly in pools, whether in their Member State or abroad. The ones that had been involved had done so in one to four pools, with the exception of one association which had been involved in around a dozen pools. Pools in which insurers' associations are or were involved cover almost all risks with the exception of Marine and Transportation. According to their replies to the survey, associations are or have been involved in various aspects of the pools activities, ranging from management and coordination of the pool, management of data exchange systems between the members of the pool and clearing and settlement of premiums and claims.

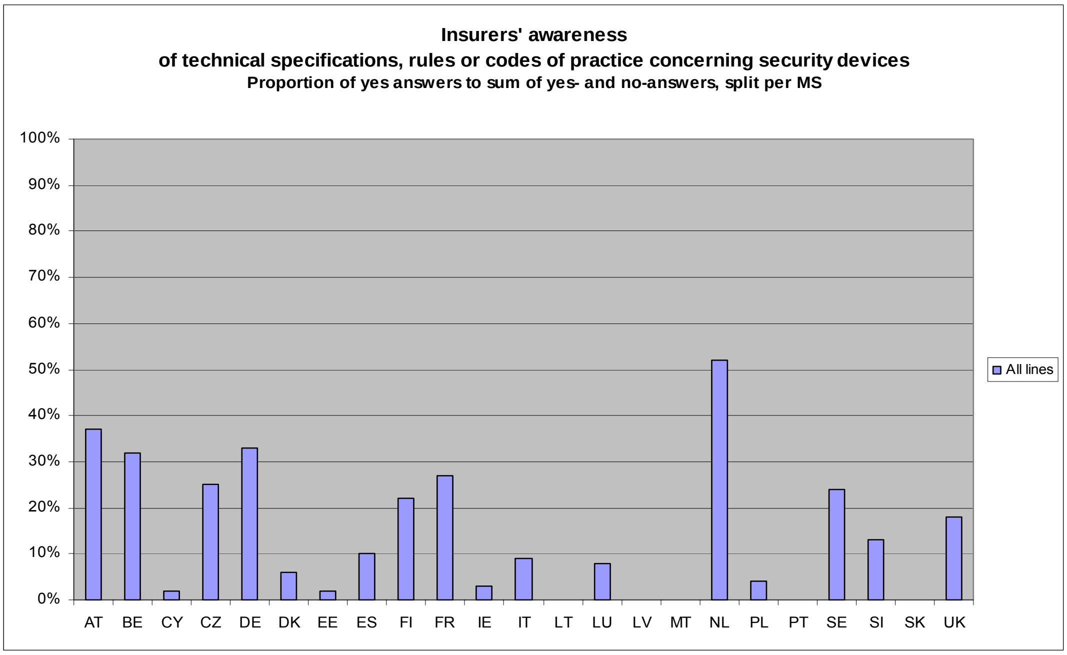
5. SECURITY DEVICES

In various Member States, insurers agree on technical specifications, rules or codes of practice concerning different sort of safety equipment (e.g., anti-fire or anti-theft devices).

The data collected from the insurance companies and from the insurers' associations show that agreements on technical specifications, rules or codes of practice are common in particular in the Netherlands, Austria and Germany. They concern mainly the Property/Business Interruption, the Transportation and the Motor insurance lines.

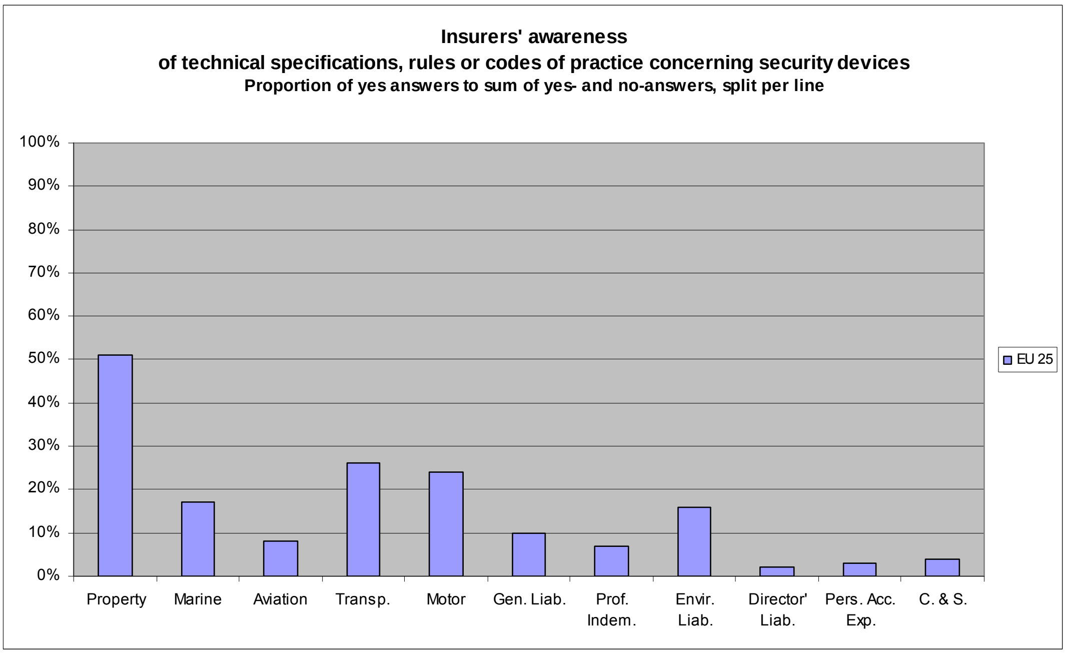
Figures X.3[161] and X.4 below show the replies of the insurance companies concerning their awareness of jointly established technical specifications, rules and codes of practice on security devices, broken down firstly by Member State and then by insurance line.

Figure X.3



Source: European Commission, Business Insurance Survey 2005-2006

Figure X.4



Source: European Commission, Business Insurance Survey 2005-2006

[161] This figure does not include data from the replies of Greek and Hungarian insurance companies as these data were of limited statistical relevance. This is due to the low number of observations related to this specific question.

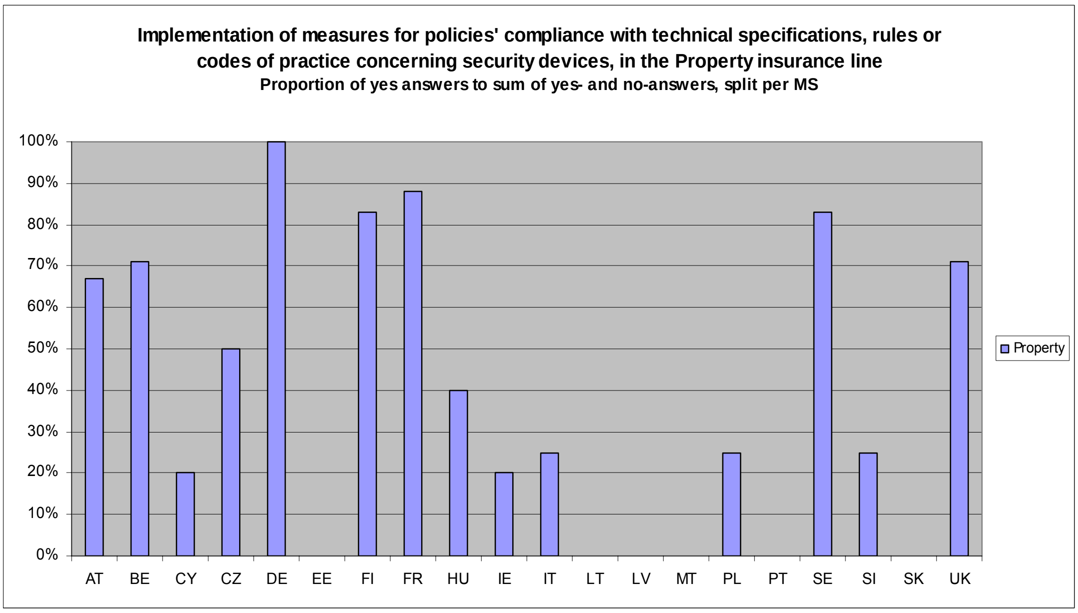
It can be observed that approximately 50 % of the Dutch insurers and 35 % of the Austrian and German insurers are aware of the existence of agreements on security devices. However, the rate of awareness does not exceed 10 % in a large number of Member States (Cyprus, Denmark, Estonia, Ireland, Italy, Lithuania, Luxembourg, Latvia, Malta, Poland, Portugal and Slovakia).

As far as the insurance lines are concerned, the data shows that approximately 50 % of the insurers active in the Property/Business Interruption insurance line and 25 % of those active in the Transportation and the Motor insurance lines are aware of agreements on security equipment. However, cooperation in this field is not substantial in the Aviation and in all the Liability insurance lines. This is confirmed by the data collected from the associations showing that the associations have not been involved in agreements on security devices concerning those lines.

Only four associations indicated that they had taken the initiative to establish standard policy conditions containing references to specifications on security equipment. This was mainly done in the Property/Business Interruption insurance line and also occasionally in the Transportation insurance line.

Referring to the practical impact of this form of cooperation, the Commission has statistically relevant data only as far as the Property/Business Interruption insurance line is concerned and only for a limited number of Member States. They show (see figure X.5 below) that more than four fifth of the German, French, Swedish and Finnish insurance companies implement measures aiming at ensuring that the risks covered by them comply with the agreed technical specifications rules or codes of practice concerning safety equipment. At the other extreme, none of the respondent insurers from Slovakia, Portugal, Malta and the Baltic Member States said that they had implemented such measures.

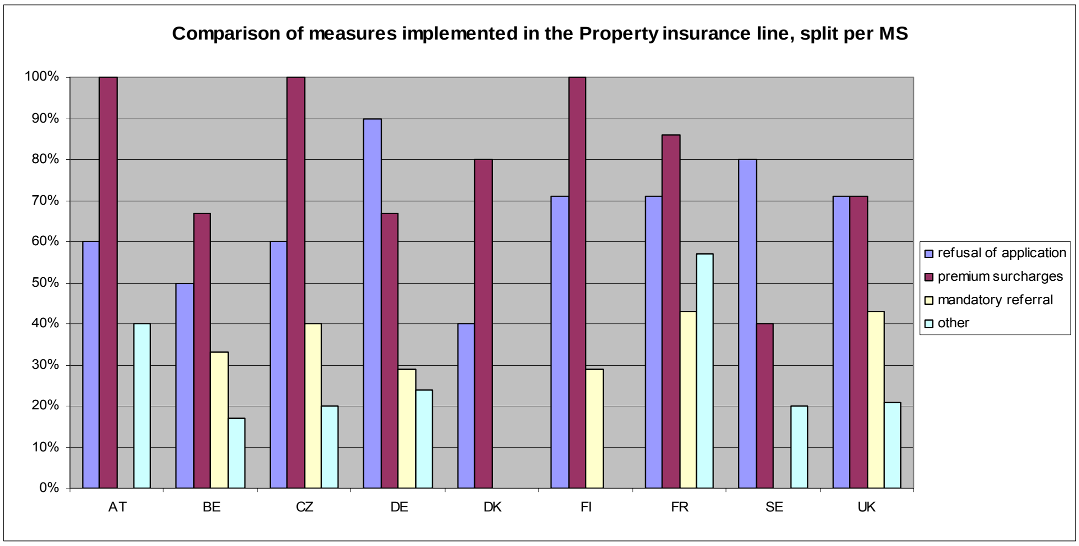
Figure X.5



Source: European Commission, Business Insurance Survey 2005-2006

As for the measures at stake, the collected data are of statistical relevance only for the Property Insurance line and for very few Member States. They show (see figure X.6 below) that the majority of the respondent insurance companies tend to impose surcharges for risks that do not comply with the agreed technical specifications, rules or codes of practice or will refuse applications referring to such risks.

Figure X.6



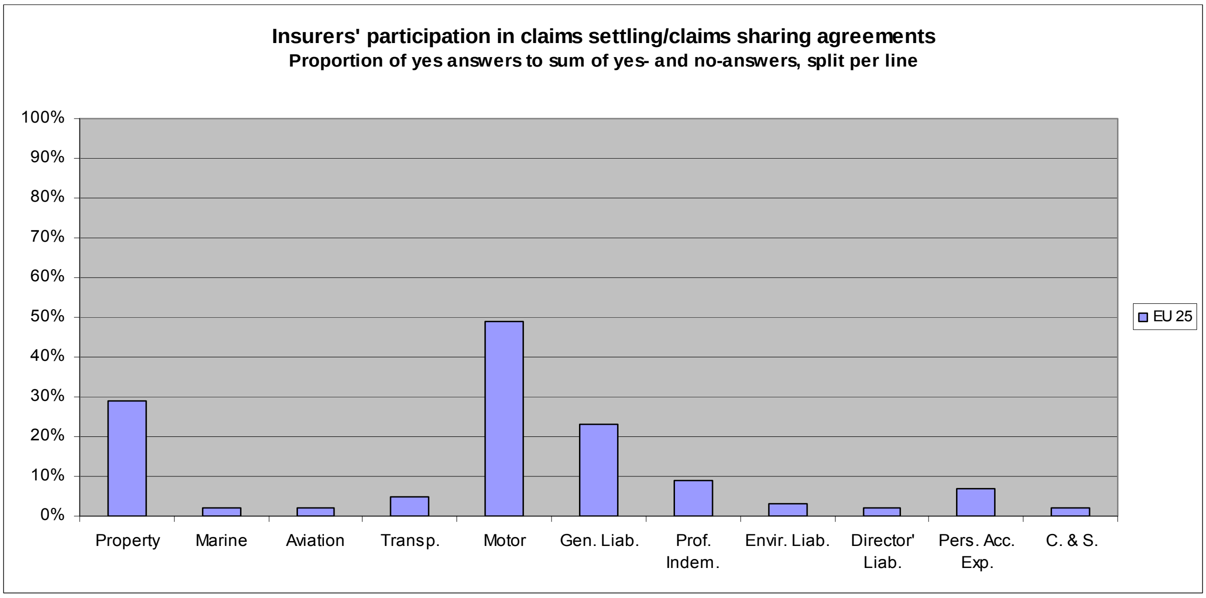
Source: European Commission, Business Insurance Survey 2005-2006

6. CLAIMS SETTLEMENT AGREEMENTS

According to the replies obtained from the associations and the insurance companies, claims settlement agreements are common in particular as far as the Motor insurance line is concerned and, to a lesser extent, in the Property/Business Interruption and in the General Liabilities lines. Conversely, this form of cooperation is insignificant as far as the other lines are concerned.

Figure X.7 below describes the participation on claim settling agreements split per line. Almost half of the insurers stated that they participate in claims settlement agreements affecting the Motor insurance line. This ratio amounts to respectively 29 and 23 % as far as the Property/Business Interruption and the General Liabilities lines are concerned. However, it is no higher than 10 % and often equal to 2% for the other lines.

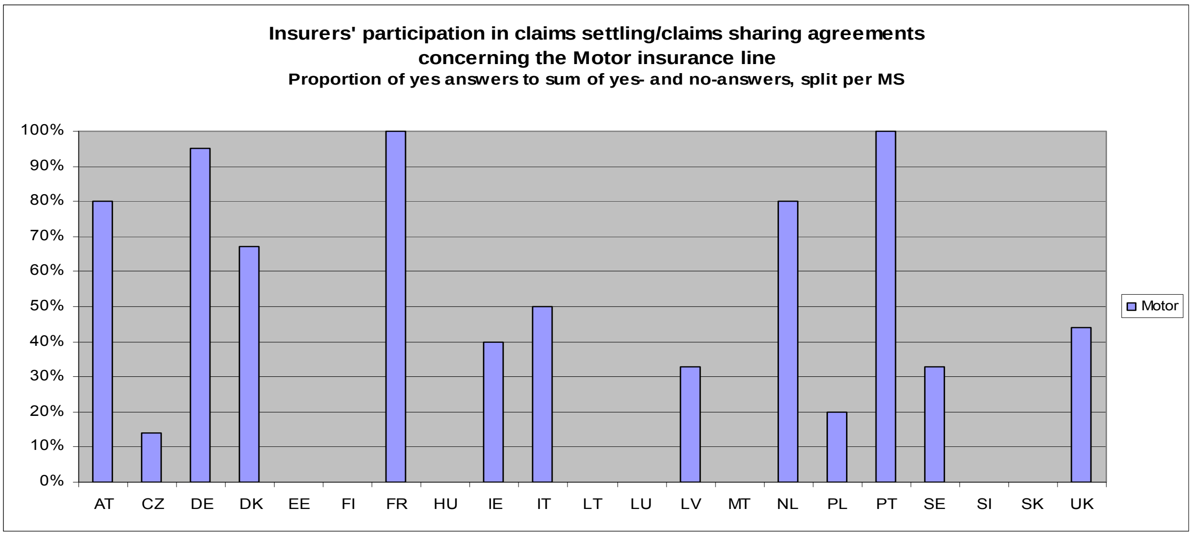
Figure X.7



Source: European Commission, Business Insurance Survey 2005-2006

If we look at the data concerning these three lines broken down by Member State (see figures X.8, X.9 and X.10[162] below), we see that this cooperation is particularly significant in Germany, in the Netherlands, in Austria, in Portugal and in Denmark as far as the Motor insurance line is concerned, and in France, in particular for the Motor and for the Property/Business Interruption insurance lines. Conversely, it seems less significant in a large number of Member States: Czech Republic, Estonia, Finland, Hungary, Lithuania, Luxembourg, Malta, Poland, Slovenia and Slovakia, as well as Italy, Ireland and the UK, as far as Property/Business Interruption and General Liability are concerned.

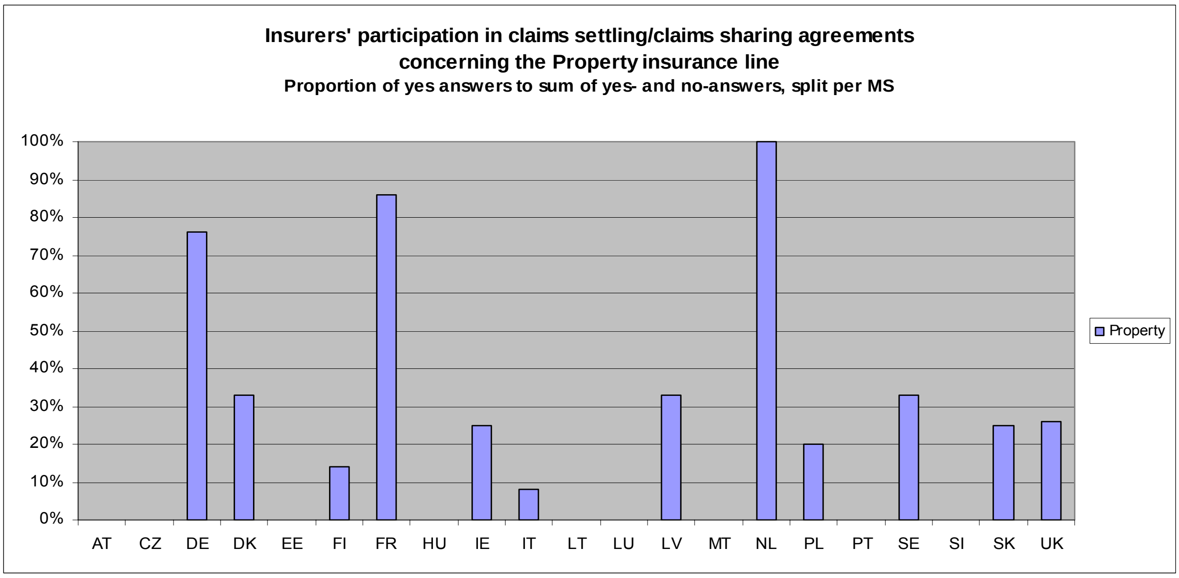
Figure X.8



Source: European Commission, Business Insurance Survey 2005-2006

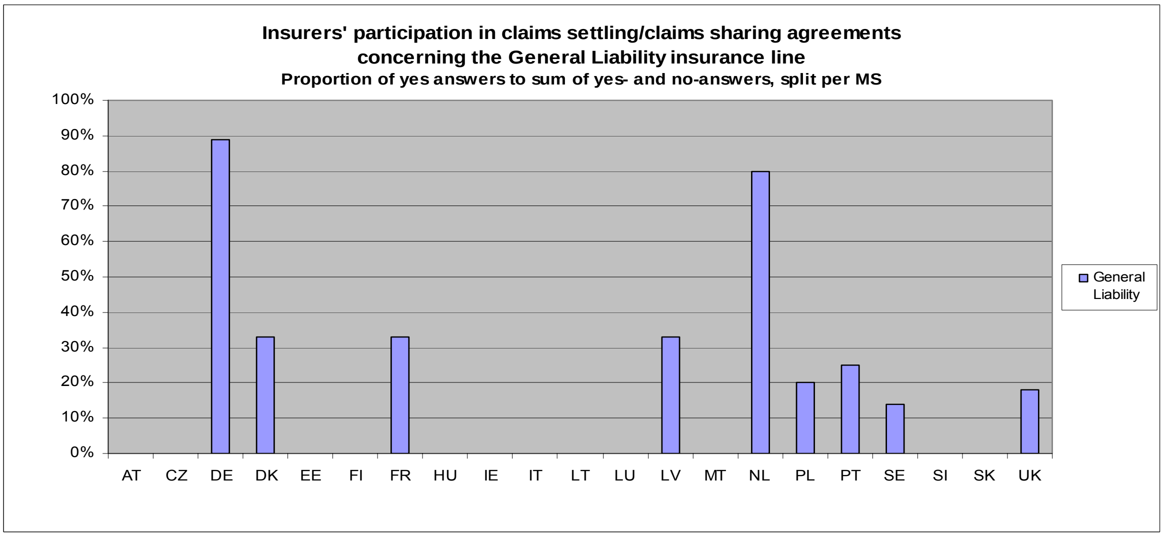
[162] These figures do not include data concerning the replies of Belgian, Cypriot, Greek and Spanish insurance companies as these data were of limited statistical relevance. This is due to the low number of observations related to this specific question.

Figure X.9



Source: European Commission, Business Insurance Survey 2005-2006

Figure X.10



Source: European Commission, Business Insurance Survey 2005-2006

The data concerning the level at which these agreements have been drafted and concluded (whether by insurers' associations, by other industry bodies, by other types of groups of insurers, bilaterally with another insurer or by social insurers), although of limited statistical relevance[163], seems to indicate that these agreements tend to be drafted and concluded at association level.

[163] This is due to the low number of observations related to this specific question.

7. ACCESS TO DATA

The data collected from the insurance companies responding to the Sector Inquiry, although of limited statistical relevance[164], shows that insurers are rarely charged for access to data from their associations in order to calculate risk premium[165].

The replies of the insurers' associations to the questions concerning the conditions at which they grant access to calculations and studies respectively for members and non-members are very varied.

As far as non-members are concerned, however, as seen in section 2, some respondents to the survey stated in their replies that they do not always make calculations and studies available to non-member insurance companies.

8. "BEST TERMS AND CONDITIONS" CLAUSE

According to information collected during the Sector Inquiry, it appears that sometimes insurers use, in co-insurance agreements, a so-called "best terms and conditions" clause. On this issue, see section 9 of chapter 8.

9. CONCLUSIONS

This chapter shows that the level of cooperation among insurers varies substantially between insurance lines and from one Member State to another.

On the basis of such differences, one could raise doubts about the justifications of such cooperation and about the scope of the exemption granted by the present Block Exemption Regulation.

The public consultation on the present Interim Report should be an occasion for an open and fruitful debate on this issue.

[164] This is due to the low number of observations related to this specific question.

[165] The percentage of positive replies varies between 0 and 67 as far as the Motor insurance line is concerned, with an average of only 12 %.

XI. CONCLUSIONS

1. FINDINGS OF THE SECTOR INQUIRY

The Sector Inquiry allowed the creation of a very comprehensive database concerning in particular the five areas on which the Commission's investigation focused (i.e. financial aspects of the business industry, duration of contracts, reinsurance, structure, function and remuneration of distribution channels and horizontal cooperation among insurers).

These data have been aggregated in order to identify patterns and trends of behaviour, at Member States and at EU level in the various business insurance lines. These findings have then been analysed under the perspective of EU competition rules.

As far as the **financial aspects of the industry** are concerned, it appears from the analysis conducted that profitability is high in business insurance at the EU-25 level. Pre-tax profitability in business insurance was around 26 % across the three largest European insurance markets in 2005 with high variation both in terms of insurance lines and Member States. Underwriting profit ratios vary up to 200 % across the EU-25 for the same insurance line and up to 100% within the same country for different insurance lines. Profitability has also been sustained over time in most Member States but is significantly higher in the new Member States than in the EU-15.

The cost bases of insurance companies vary considerably across the EU-25 and are not converging. In particular, insurers in the new Member States display consistently higher cost ratios than those in the EU-15. It thus seems that at Member State level, less efficient markets also display higher profitability.

The extent of variation in profitability indicates an important degree of market fragmentation and the potential scale for price reduction in several Member States. High and sustained profitability in some Member States may be the result of the exercise of market power. Further investigation will focus on possible causality between financial performances and possible barriers to competition in some markets.

Finally, it is worth noting that some Member States tend to display consistently higher underwriting profitability in segments of small and medium-sized enterprises (SMEs) than in segments of large corporate clients (LCCs). This might indicate that in these Member States, underwriting for SMEs is used to cross-subsidise low returns in the LCCs' segment.

On the **duration of business insurance contracts**, the inquiry's data show that the average duration of insurance contracts for a given line varies substantially between Member States. While in many Member States the majority of the insurance contracts are concluded on an annual basis, long-term agreements are common practice in some other Member States, such as Austria, Italy, the Netherlands and Slovenia.

Moreover, clauses allowing for the automatic renewal or extension of contracts are common.

The data do not show a substantial difference between practices concerning LCCs and practices concerning SMEs.

In certain cases, the duration of the insurance coverage offered by a contract is an essential characteristic of the product that is defined and marketed by the insurance company. As long as duration of coverage is inherent to product definition, it seems doubtful that it could be seen as a restriction of competition. However, when this is not the case, long-term agreements in the business insurance sector can, under certain circumstances, raise competition concerns related to the risk of foreclosure of the insurance markets to new entrants.

The assessment of the foreclosure effects of long-term agreements will notably depend on the cumulative effect that networks of similar long-term contracts will have on access to the market. It will also depend on the appraisal of other factors pertaining to the economic and legal context of the agreement. These factors are related, on one side, to the possibilities for a new competitor to penetrate the bundle of contracts and, on the other, to the conditions under which competitive forces operate on the relevant market. Finally, 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 the similar contracts found on that market.

Further investigation will assess the likelihood of these risks of foreclosure.

On **reinsurance**, the Commission's survey shows that 91 % of insurers take into account financial ratings when selecting reinsurers and that 95 % of these insurers have defined a minimum rating below which they would not consider buying reinsurance from any reinsurer. This raises the question of the demand-side substitutability of the different reinsurers and thus whether ratings may affect in specific cases the definition of the product market.

The inquiry also shows that reinsurance companies active in the EU include the so-called "best terms and conditions" clause in their contracts with their clients, the direct insurers. This clause allows a given reinsurer to benefit from any more favourable terms that could have been agreed between the same direct insurer and another reinsurer within the same reinsurance arrangement. The clause harmonises terms and conditions at the most favourable level for the reinsurers concerned, irrespective of the characteristics of these reinsurers, to the detriment of the direct insurer and, ultimately, of the final business insurance customer. The clause also increases price transparency and, under certain market conditions, could amount to a restriction of competition within the meaning of Article 81(1) EC. Some respondents, however, advanced arguments in order to justify the practice.

On **distribution channels** for business insurance products, the replies from insurers and intermediaries show that the ***structure*** of the various distribution channels (direct distribution, exclusive agents, multiple agents, brokers, banks or other financial institutions) varies from one Member State to another due to historical and cultural reasons. Differences also exist according to the different lines of products and/or client profiles. The business insurance market is predominantly served by brokers. Exclusive agents constitute the second most used channel of distribution in most lines of products. 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.

The ***function*** of intermediaries, especially brokers, has changed over the last twenty years extending from the traditional role of market-matchers, whose services relate to the transferring of risk from the clients to the insurers, to the role of service providers to clients and to insurers. When brokers act both as a distribution channel for the insurer and as an advisor to their clients, they assume a dual role which is a potential source of conflict of interest, which need to be examined.

Another source of conflicts of interest could be the ***form of remuneration***. In particular, contingent commissions (i.e. payments made by insurers to intermediaries, based on the achievement of agreed targets) could create incentives for intermediaries to steer high volume or profitable business to selected insurance companies, not necessarily in the interest of clients. The survey confirms that contingent commission agreements were widespread in many Member States in the past, particularly in the EU-15. Some intermediaries have derived considerable revenues from contingent commissions, highlighting the potential for conflicts of interest. It appears that the investigation in the US and the increased public attention have led some market participants to change their policy concerning contingent commission agreements, but not necessarily to abandon all contingent commissions. Other market participants have made no changes to their practices. The Commission intends to further examine this issue.

Moreover, the survey shows that intermediaries across the EU tend not to declare to their clients spontaneously how they are remunerated for the placement of insurance. The overall lack of transparency of intermediaries' remuneration, which was also criticised by risk managers in the Commission's survey, reduces, however, the potential for price competition in relation to mediation services. The Commission intend to further look into this issue, actively involving clients of business insurance.

As for commission rebating, its prohibition by insurers could amount to resale price maintenance and could therefore constitute a restriction of competition which would not benefit from the block exemption granted by the Regulation on vertical agreements and concerted practices. The Commission will further examine in additional questionnaires to which extent commission rebating takes place and whether or not there are agreements or practices that would prevent intermediaries from rebating commissions to broking clients.

The Sector Inquiry shows that **horizontal cooperation among insurers** varies substantially between insurance lines and from one Member State to another.

On the basis of such differences, one could raise doubts about the justifications of such cooperation and about the scope of the exemption granted by the present Block Exemption Regulation.

The public consultation on the present Interim Report should be an occasion for an open and fruitful debate on this issue.

2. NEXT STEPS

Notwithstanding the fact that the database created is already very comprehensive, the Commission considers appropriate to conduct an additional targeted round of investigative steps (questionnaires and/or interviews) with various stakeholders.

In particular, sometimes, due to the complexity of the questionnaires sent to the various market operators and to the significant efforts that data gathering meant, in particular for insurers and intermediaries of medium/small size, replies were not always as clear, accurate and exhaustive as expected. The supplementary investigations will help clarifying certain issues that emerged from the replies received so far.

The supplementary investigations will also sharpen the competition focus of the Sector Inquiry into Business Insurance as the Commission will concentrate these further investigations on concrete issues raising competition concerns that have been identified.

Moreover, the Commission will pro-actively involve the customer side of business insurance (i.e. SMEs and LCCs) via their associations, in order to be able to present in the Final Report a balanced view of the issues at stake.

With the publication of the present Interim Report, the Commission launches a public consultation, creating the conditions for an open and fruitful debate on the various issues raised in the Report. The public consultation period will end on 10 April 2007.

On 9 February 2007, a public Hearing will take place in Brussels with the participation of all stakeholders: insurance companies, intermediaries, insurers' and intermediaries' associations, regulators and associations representing business insurance customers.

The Final Report of the Sector Inquiry, which will present the findings of the new round of investigative steps and comment on relevant issues raised during the public consultation and the Hearing, will be published in September 2007.

3. Issues for consultation

The Commission is keen to engage in dialogue with market participants and authorities about the preliminary findings of the Sector Inquiry presented in the Interim Report. Therefore, the Commission invites industry participants, business insurance customers and other interested parties to submit their views and comments on such preliminary findings. In addition, stakeholders are welcome to contact the Commission directly in order to discuss any competition related issue in business insurance.

The Commission has highlighted a set of issues for consultation. This will enable stakeholders to put forward their views on the key questions. However, **any other comment of all stakeholders on the preliminary findings presented in the Interim Report, not directly related to the issues identified below, is also very welcome.**

The issues for consultation that the Commission has highlighted are the following:

Discrepancy of combined ratios

Q.1 Are there compelling justifications for the apparent discrepancy in the level of combined ratios of SMEs and LCCs observed in some parts of the EU-25?

"Best terms and conditions" clause

Q.2 How widespread is the use of the so-called "best terms and conditions" clause in the reinsurance and in the co-insurance markets? Where does this type of clause originate?

Q.3 At what stage in negotiation does this type of clause appear and which/how many participants ask for its introduction?

Q.4 How is the clause enforced?

Q.5 What is the effect of this type of clause on the market?

Long-term agreements

Q.6 Have you experienced that the duration of insurance contracts represented a barrier to entry for insurers wishing to penetrate new markets and/or acquire new customers? Please explain your answer also taking into account the existence of termination and of automatic renewal/extension clauses.

Q.7 Have you experienced that the duration of insurance contracts was a serious obstacle for switching to a different insurer? Please explain your answer also taking into account the existence of termination and of automatic renewal/extension clauses.

Intermediaries' remuneration

Q.8 To what extent do independent insurance intermediaries (brokers and multiple agents) disclose remuneration paid by insurers (i.e. commissions, contingent commissions including profit commissions, fees for services provided and other payments) to their insurance broking clients?

Commission rebating

Q.9 In your Member State, do independent insurance intermediaries rebate commissions to their clients? How common is this practice for SME clients? How common is it for LCCs?

Q.10 Are there any agreements between insurers and independent intermediaries not to rebate commissions to insurance broking clients? Are there any other practices that would discourage independent insurance intermediaries from rebating commissions to insurance broking clients?

Horizontal cooperation

Q.11 The inquiry's data concerning the various forms of cooperation among insurers shows substantial differences among Member States. How can these differences be explained?

Q.12 Which sorts of benefits have you experienced, as a business insurance customer, from the forms of cooperation among insurers described in the present Report?

Q.13 As a business insurance customer, have you ever experienced that the forms of cooperation among insurers described in the present Report were hindering competition?

4. PROCEDURE FOR CONSULTATION

The consultation will be open for 12 weeks and will close on **10 April 2007**.

Replies should be sent to the email address:

Comp-Ins-Inquiry-Feedback@ec.europa.eu.

Respondents are strongly encouraged to provide a reply of not more than 20 pages to allow for efficient treatment of the feedback by the Commission. There shall be only one submission of comments per undertaking.

Respondents are advised that their contributions may be published on the Commission's website.

In view of the sensitive nature of such evidence, market participants may wish to provide submissions to the Commission on an informal and confidential basis. The Commission will assume responsibility for preserving the confidentiality of any material provided.

Please indicate in your reply whether you **do not** authorise the Commission to publish your contribution. In case your comments contain confidential information, please provide a non confidential version.

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 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 M EUR (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.