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Response to European Commission inquiry into the European business insurance sector pursuant to Article 17 of Regulation 1/2003

Executive summary

- The ABI believes the Commission is correct to place business policyholders at the centre of the business insurance inquiry. In the UK, the main guarantee of good service and keen prices to the policyholder is the highly competitive nature of the British insurance market. The Commission's report provides valuable research and market analysis about the business insurance industry.

- The ABI questions the methodology of the Commission's analysis of combined ratios. Unfortunately, this has led to invalid conclusions on the profitability of the business insurance market. In particular, the Commission has paid insufficient attention to the insurance business cycle. We believe that the UK market for SMEs is as competitive as the market for large companies.

- At present, national rules on disclosure of intermediaries' remuneration reflect the unique conditions of individual markets. In the UK business insurance market, details of intermediaries' remuneration are available on request. The ABI believes that the rules are appropriate, and provide protection for buyers of business insurance in the UK. We do not believe that the preliminary report makes a case for EU-level legislation on disclosure of intermediaries' remuneration.

- The nature of insurance means that policyholders derive benefit from a certain level of co-operation between insurers. The existence of the Block Exemption provides legal certainty for these activities. The ABI notes that the Block Exemption Regulation is due for review by 2010.

Introduction

The Association of British Insurers (ABI) is the trade body that represents the collective interests of the UK's insurance industry. The ABI currently has around 400 members. These insurers provide nearly 94% of the domestic insurance services sold in the UK. ABI member companies are prominent institutional investors and account for almost 17% of investments in the London stock market. As at 31 December 2005, the insurance industry in Great Britain had about £1,330 billion invested in company shares and other assets on behalf of millions of savers and general insurance customers in the UK and elsewhere.

The ABI has responded to the Commission's consultation questions, and will be happy to provide any further information the Commission requires. We note that responding to the Commission's questionnaires has generated significant additional administrative expense and legal fees for our members. We urge the Commission to close this Inquiry rapidly.

Evidence shows that the British business insurance market is highly competitive. This has huge advantages from the point of view of the business policyholder. The costs of switching insurance provider are low. British insurers use sophisticated risk-pricing techniques to ensure that policies are closely tailored to the needs of the policyholders, and that prices are keen. The British business insurance market is well served by full service brokers, whose role is to offer business customers the deal that best meets their needs, from all carriers' offerings. Looked at from the supply side, the low barriers to entry to the British market are demonstrated by the increasing importance of foreign capital. The number of foreign-owned insurers in the UK stood at 21% of the market in 2002, up from 16.8% in 1990. As far as general insurance is concerned, the market share of foreign-owned firms has remained about 30% since 2002 (see Figure 1 in the Annex). This evidence confirms a picture of a business insurance market characterised by stiff competition, and open to new sources of insurance capacity.

Profitability

The ABI questions the validity of the Commission's analysis of combined ratios, and the Commission's choice of the period to analyse. This has led to incorrect conclusions on the profitability of the business insurance market. In particular, the report pays insufficient attention to the impact of the insurance business cycle. We encourage the Commission to consider the evidence based on more traditional indices of concentration, before reaching conclusions about market power that may prove hard to substantiate.

Comparison of SMEs' and large companies' experience:

The Commission's report suggests that differences in profitability in the SME and large company segments may indicate cross-subsidisation from one segment to another. We have difficulty in commenting authoritatively on the Commission's findings, as the figures collected by the ABI do not separate data in this way. However, the Commission’s conclusions do not sound right, as experience suggests that the British market for insuring SMEs is highly competitive. Furthermore, while there is some overlap, the insurers competing in the different segments are not the same, therefore reducing the opportunity for cross-subsidy.

It is also worth recalling that insurance products sold to large companies are very different from those sold to SMEs. The Commission’s report itself notes that “large business risks are often complex and unique in their characteristics” (section 1.1.2 of the report). The different characteristics of insurance products for SMEs and large companies may invalidate direct comparisons between these markets and their profitability. In general, we do not believe that the Commission’s overall analysis of profitability based on analysis of the combined ratio leads to sound conclusions, and we suspect that the analysis on SMES and large companies may suffer from similar shortcomings.

Q.1 - Discrepancy of combined ratios
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?

Please see the Annex, *"Profitability and concentration in the UK general insurance market"* for a detailed response. We have taken general insurance as a proxy for business insurance, as reliable statistics are available. We accept that there are differences of scope, but we believe that the conclusions for general insurance hold good for business insurance also.

The UK's general insurance market is highly competitive and contestable in all sectors of business insurance. On the demand side, customers face low switching costs and a wide choice of insurers. On the supply side, the British market is open and contestable. Low entry barriers have led to the Financial Services Authority (FSA) authorising 1,118 insurance companies to do business in the UK - 836 (75%) of which carry out general insurance. Market entry is facilitated by an extensive network of brokers offering full market analysis, which helps new entrants access distribution channels.

The UK's insurance market is also attractive to foreign-owned insurers. According to the FSA, the percentage of foreign-owned insurers in the UK was 21% in 2002 (up from 16.8% in 1990). Figure 1 of the Annex demonstrates that the market share of foreign companies conducting general insurance has remained above 30% since 2002.

Cyclical nature of the insurance market:

The ABI is concerned that the Commission's profitability analysis does not take into account the cyclical nature of the insurance market. Figures 3, 4 and 5 of the Annex highlight the importance of considering the overall business cycle of business insurance products when considering market profitability. A snapshot of the industry's underwriting profits, over a relatively short period of time, may lead to flawed conclusions – either an underestimation or an overestimation of average returns. While underwriting results of UK general insurance businesses generally improved in 2004 and 2005 (with the exception of motor insurance), all major business insurance classes performed badly during the 1995-2005 period.

Combined ratio:

The Commission's report uses the combined ratio (CR) of different lines of business in general insurance to proxy profitability measures across member states. Figure 6 of the Annex demonstrates that it was only in 2004 and 2005 that the UK's insurance market achieved underwriting profits; during the second half of the 1990s the CR was above 100% which indicates that the industry was making losses on underwriting business during that period. This again highlights the need to take account of the full cycle of the business insurance market, which normally lasts for 6 to 9 years.

Investment income:

Investment income comprises the financial returns on assets purchased with insurance premiums that are held by the company until claims and associated expenses are paid. The preliminary report used combined ratios and net investment results to calculate a proxy for industry profitability. The Commission used headline figures published in Swiss Re (2006a) to conclude that the annual net investment results of the UK general insurance industry over the period 1994-2004 was 16.8%.

In fact, figure 8 of the Annex illustrates that the net investment return of the UK general insurance industry over the period 1995-2005 was 11.8% rather than the 16.8% calculated by the Commission. The Commission then concluded that the average pre-tax profit for business insurance was 26% across the three largest European insurance markets. ABI analysis, presented in figure 9 of the Annex, concludes that the profitability of British general insurers, based on the same methodology as the Commission, was only a modest 9% for the period of 1995-2005.

“Best terms and conditions” clauses

Q.2 – “Best terms and conditions” clause
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?

The ABI understands that the “best terms and conditions” clause has a long history in UK reinsurance negotiations, though its use is infrequent in the present day. We have not come across this clause often, and the following comments are by way of explanation. We neither defend nor criticize the use of the clause.

Some complex reinsurance placements may involve many carriers. The “best terms and conditions” clause assists the market to place 100% of the insurance schedule. The clause works by allowing reinsurers, who wish to take on a share of a particular contract, to do so only on condition that they are allowed to change the price or terms for all participants. The effect of the “best terms and conditions” clause is therefore that these new terms and conditions then apply to all the other reinsurers participating in the contract. This can allow more carriers to participate in completing the schedule The clause also ensures that the contract terms and conditions are consistent for all participants, including the customer. This may contribute to ‘contract certainty’ and avoid differences in cover, claims disputes or partial payments of claims with the incumbent legal costs.

Business insurance of this type is typically brokered by professional business insurance or reinsurance brokers, who are at liberty to accept or reject the terms of participating carriers, if the terms and conditions are not acceptable.

Q.3 - At what stage in negotiation does this type of clause appear and which/how many participants ask for its introduction?

The clause is commonly applied by the lead reinsurer/insurer when their terms and conditions and their lead proportion are agreed with the placing insurance broker or customer.

Q.4 - How is the clause enforced?

The lead reinsurer/insurer will prepare the contract on the basis of the terms and conditions agreed by subsequent participants in the contract if they differ from the lead carrier's terms and conditions. If there are no changes required by the following carriers, the lead carrier will issue the contract on the basis of the original terms and conditions they agreed when accepting their lead proportion.

***Q.5* - What is the effect of this type of clause on the market?**

See Q2 above. The ABI understands that the market and customers have certainty that the contract terms and conditions are consistent for all risk carriers. Flexibility to alter terms and conditions can provide greater market capacity for customers.

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.

Long-term contracts are not common in the UK and rarely exceed 24 months duration. If they are used, it is usually at the request of the customer. Some customers actually request long-term contracts, for example to cover the term of a construction project.

Long-term agreements/undertakings in the UK generally bind insurers to their initial premium rates at subsequent annual renewals - typically for 3 or 5 years. If the insurer increases their premium rates at a renewal, the customer is not bound to renew the contract. In exchange for the commitment by the customer, the customer receives a discounted rate.

This kind of arrangement, as practised in the UK, leads to no foreclosure of the market, which we believe is competitive. The contracts in question are too short and insufficiently widespread to have any effect of market foreclosure.

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.

Not applicable.

Distribution

Q.8 – Intermediaries' remuneration

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?

In the UK, the Financial Services Authority's (FSA) rules require that, when a business customer requests disclosure of the commission received by the intermediary, the intermediary must disclose the amount to the customer[1]. FSA rules also require intermediaries to ensure their fees to clients are clearly described.

The ABI believes that the current FSA rules of *disclosure on request* provide customers with a right to relevant information. We fully support the customer's right to information about the sales process and intermediary remuneration. However, we are not convinced that disclosure should be mandatory. The British Insurance Brokers Association (BIBA) has recommended to their members that they include a clause in their terms of business agreements with their business clients, reminding their clients of their right to request disclosure of commission paid to their intermediary. However, BIBA has found that the extent to which business clients request intermediaries to disclose their commission varies enormously in practice.

At present, national rules on disclosure of intermediaries' remuneration reflect the unique conditions of individual markets. The ABI believes that the rules in the British market, which is the only market on which we are qualified to comment, are appropriate, and provide protection to business customers. The FSA is currently reviewing commission disclosure in the British market, and will publish results at the end of 2007.

We are aware that other EU markets have a variety of different arrangements. This situation raises the question whether there would be advantage in EU level rules on disclosure of intermediaries' remuneration. This is a highly complex area, with many difficult issues of definition. There is a high risk that EU regulation on this issue may unintentionally disrupt national markets by imposing common rules on markets which have, for perfectly good reasons, developed very differently. We do not believe that the Commission's preliminary report makes a case for EU-level disclosure legislation. Any moves to consider EU-level regulation, should be subject to the principles of

[1] FSA ICOB 4.6.1. Before the conclusion of a non-investment insurance contract, or at any other time, an insurance intermediary that conducts insurance mediation activities for a commercial customer must, if that commercial customer asks, promptly disclose the commission that he and any associate of his receives in connection with the non-investment insurance contract in question, in cash terms or, to the extent it cannot be indicated in cash terms, the basis for the calculation of the commission, in a durable medium.

Better Regulation, including a full consultation process and rigorous cost/benefit analysis.

Conflicts of interest:

FSA rules require firms to manage potential conflicts of interest[2]. Brokers are obliged to manage conflicts of interest in a way that provides confidence to both the insured and the insurer. Under the Insurance Mediation Directive's Status disclosure requirements[3], the role of an intermediary and the basis of any advice given should be made clear to the customer.

Q9 - Commission rebating
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?

It is not unusual in the UK, for independent intermediaries to rebate part of their commission to their clients. The intermediaries use the rebate as an inducement to clients to retain their services, by reducing the overall cost to their clients. We have no evidence of the exact extent of rebating, or of any different characteristics of the SME and large company markets in this respect.

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?

We are not aware of such restrictive practices in the UK.

<u>Block Exemption Regulation</u>

Q.11 - Horizontal cooperation
The inquiry's data concerning the various forms of cooperation among insurers shows substantial differences among Member States. How can these differences be explained?

National insurance markets have independently developed their own customs and practices, so it should be no surprise that the extent of cooperation varies. Many of these differences are legal in nature. For example, liability rules differ between national markets, and national courts have reached

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2 Principle 8 in the FSA Handbook on 'Conflicts of interest' is one of the 11 high level principles applying to all FSA regulated firms: http://fsahandbook.info/FSA/html/handbook/PRIN/2/1. ICOB 2.3 from the FSA Handbook on inducements also includes rules to ensure that a firm does not conduct business under arrangements that might give rise to a conflict with its duty to customers: http://fsahandbook.info/FSA/html/handbook/ICOB/2/3

3 Article 12.2 of the Insurance Mediation Directive requires intermediaries to disclose the basis of any advice given. "When the insurance intermediary informs the customer that he gives his advice on the basis of a fair analysis, he is obliged to give that advice on the basis of an analysis of a sufficiently large number of insurance contracts available on the market, to enable him to make a recommendation, in accordance with professional criteria, regarding which insurance contract would be adequate to meet the customer's needs." FSA Handbook rules also require intermediaries to declare their status to customers: http://fsahandbook.info/FSA/html/handbook/ICOB/4/2

differing judgments on the nature of negligence and the levels of compensation to be paid. The Commission's report itself notes (in Section VI.1), that price comparisons are difficult because seemingly similar products may be of a very different nature. Inevitably this leads to different patterns of co-operation between insurers. To take a simple example from motor insurance, in France there is a mandatory note, which has to be filled in by all parties to an accident. All parties' insurers are therefore rapidly aware of the accident. In the UK there is no such system, and it may take some time for all insurers to be aware.

The Commission's report (in section V.2.5) draws attention to the possibility that insurance products are developed in national markets to meet different market conditions. As the Commission notes, most insurance has continued to be written locally, with insurers preferring to establish or purchase local companies in another member state, and increasing competition in that market by these means. The relevant insurance markets are therefore national. Accordingly the use of the block exemption, and its value to policyholders, varies according to circumstances in those national markets.

The ABI favours the retention of the Block Exemption Regulation and believes the Commission's report should take account of the use of the Block Exemption across the insurance sector, not just in respect of business insurance. The Block Exemption permits the market to operate efficiently for the benefit of customers, and provides legal certainty for the following activities:

- <u>Joint Studies and Calculation of Risks</u>: the Block Exemption covers co-operation between insurers to calculate the average cost of risk cover based on historical data. The Block Exemption also allows insurers to carry out joint studies relating to the impact of external factors on the frequency and scale of claims. The ABI's response to the Commission's questionnaire draws attention to a number of useful studies of this kind;
- <u>Standard Policy Conditions and Models</u>: the availability of non-binding standard policy wordings for use by insurers, can assist new entrants to break into markets, especially niche markets, thereby fostering competition. The existence of model wordings speeds up the drafting of contracts, thus contributing to the increased contract certainty required by the FSA;
- <u>Insurance Pools</u>: in practice, certain risks can only be insured via the participation of several insurers. For example, the British Nuclear Insurance pool in the UK. As a niche operation (few businesses to insure but high liability exposures), insurers have solved the difficulty of providing enough insurance capacity (for both liability and property risks), by forming an insurance pool. The pool works by gathering insurance capacity from across the market, in order to provide the insurance cover required;
- <u>Security Devices</u>: the security device exemption permits customers to install security equipment in the knowledge that it meets the standards that will almost certainly be required by other insurers, thereby avoiding additional costs. Agreed standards for security devices are therefore an important tool to keep claims costs down, and to prevent damage (also uncovered damage) to the insured.

The ABI notes that the Block Exemption Regulation is due for review by 2010.

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?

Not applicable

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?

Not applicable.

Association of British Insurers
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