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**International Underwriting Association of London's (IUA) comments on the Interim Report on the European Business Insurance Sector Inquiry**

Dear Ms Schwimann,

Thank you for inviting feedback on the Interim Report on the European business insurance sector inquiry. IUA is a member of the Comité Européen des Assurances ("CEA") and we fully support the views they have submitted on behalf of the European insurance industry as a whole. Furthermore, given the distinctive nature of the London Insurance market, we also wish to comment on aspects that are of particular relevance to our members. These comments, therefore, are supplementary to the CEA comments.

As you may know, IUA is an association of international insurance and reinsurance companies providing services in London. For further information about us, please refer to the attached note.

**1. The London Insurance Market**

The London Insurance Market is a very important element within the EU and global insurance industry. Its main business is internationally traded insurance and reinsurance services, including the coverage of the very large risks of multinationals and UK companies. This business is predominantly non-life insurance and reinsurance, with a strong emphasis on high-exposure risks. Nearly all the entities active in the London Market are either members of the IUA or operate as Lloyd's syndicates (which we do not represent).

As noted in the Interim Report, the London Market remains the leading centre for marine, aviation, transport and energy insurance and for internationally traded reinsurance.

Many risks are written on a subscription or co-insurance basis where, rather than being invited to underwrite 100% of a risk, insurers or reinsurers are able to accept a (variable) proportion of it. The risk is not shared; it is subscribed to, with each company taking a separate part, according to its underwriting capacity and risk appetite. That has the advantage for both customers and providers of spreading and diversifying risk, thus making it possible to meet client capacity needs without overwhelming catastrophe exposure to a single insurance entity. This ability to “syndicate” risk to several underwriters has traditionally been one of the key benefits and main attractions of the London Market. It allows underwriters, large and small, to participate in covering difficult, or complex, or very large risks which smaller undertakings would be too small to underwrite, and which larger undertakings would probably choose not to insure alone. The customer derives benefits from the diversification of risk and from the competition among a far larger pool of companies and syndicates that can compete to take a share of every risk that they are competent to underwrite. International competition between major insurers and reinsurers can sometimes be constrained by geographical, legal, administrative and cultural barriers, but the London Market provides a commercial forum where all insurers/reinsurers compete together freely and fully.

We would be happy to provide more detailed commentary on the operation of the London subscription market. The key point, however, is that the London Market is highly competitive and has very low barriers to entry beyond competence and adequacy of capital.

## **2. General Comments on the Interim Report**

The Interim Report displays an understanding of the importance of the essential function fulfilled by insurance and reinsurance in the European and global economy. Overall it seems to show an industry which is working well and to give a reasonable bill of health with regard to competitiveness.

Some possibly misleading conclusions may, however, have been drawn from data that is not sufficiently robust to serve as the basis for a complete competitive analysis. In this regard, please find below our comments on some of the areas that the report identifies as deserving further investigation. We hope that they may assist you in considering further how the UK and especially the London industry organises its business to best serve its customers in a competitive market.

## **3. Block exemptions: General comment**

The IUA's members regard the maintenance of the exemptions provided by the Insurance Block Exemption Regulation as being of crucial importance to their

endeavours. They have assisted in providing insurers and reinsurers with a relatively clear framework of competition law within which to trade and develop business plans for future activity. The certainty to companies in the conduct of their business and decision-making help to alleviate administrative burden and the need to have regular recourse to costly internal or external legal counsel. It makes sense for the market as a whole not to have to purchase similar advice many times over – which creates delays, costs and inefficiencies to the detriment of customers.

This is crucial in jurisdictions like the UK where infringement of competition law carries criminal sanctions and business people need to feel confident as to what is permitted.

It is of particular relevance in the insurance industry where co-insurance, pooling and some re-insurance necessitates cooperation between otherwise competing firms. The completion of a single large and/or complex risk cover necessarily requires the combination of many insurers' separate capital such that policy forms and bespoke cover must be reviewed and understood by several insurers in common. The clarity in these transactions is vitally important as is recognised by the McCarran-Ferguson exemptions in the USA.

It also appears from the Interim Report that the greatest use of the block exemptions is in the Member States that are the most mature, the most competitive and the most efficient in pricing. In our view, if the other Member States tend to use the block exemptions less, it is because they are less mature, and less well organised to meet customer need through the efficiencies of coinsurance made possible by the block exemptions.

The clarity given by the exemptions to produce statistical information and pooling cover also increases the efficiency of the industry and its ability to respond to customer need.

### **3.1 Block Exemptions: Model Wordings**

#### **3.1.1 London Market model wordings**

For the international London Market, where large numbers of underwriters are dealing with large corporate clients, the availability of model wordings is essential to the efficiency of the market. Over many years, a body of model contract wordings and accompanying jurisprudence has evolved that gives both customers and providers a good degree of legal certainty regarding the interpretation of contracts and the intentions of the contracting parties. In the absence of model wordings, each contract would need to be negotiated and drafted without the

advantages of previous experience, the application of the jurisprudence would be less certain and there would be much less transparency and greater scope for misinterpretation of meanings and intentions. The legal costs in agreeing a completely new wording for every similar contract would be uneconomic to both contracting parties and would ultimately be reflected in the cost to the customers of providing insurance and reinsurance cover.

In addition, the purpose of many model wordings is to reflect legislative requirements. Insurance contracts must not conflict with legal definitions of liability or with mandatory obligations placed on insurers and insureds. In these circumstances, model wordings that reproduce legislative requirements that everyone understands and whose legal interpretation is well established are in the interests of all contracting parties.

The model wordings are used by brokers and underwriters to set out clearly what is being insured or reinsured and tailor the contract to the individual client's need. They are essential building blocks in the construction of most contracts, providing certainty between the contracting parties about the meaning of the words used and the intentions of the parties. Many contracts are an amalgamation of individual model clauses and are generally renewed annually so as to enable the parties (usually large commercial concerns) to review and modify the words to suit their current needs. The London Company Market wordings are moreover only one source of coverage description; clauses and language from a significant range of alternative sources are used by brokers and underwriters to reach agreement on individual contracts.

Each model wording available in the London Market is of course no more than illustrative. There is no compulsion to use any particular wording and underwriters and brokers draft each contract using their choice of model wordings or other language/modification/variations to suit their purposes. Clients, brokers, insurers and reinsurers all consider the model wordings to be an integral and necessary part of the market. In a sense, the wordings are the basic language of exchange used in the market. Each side knows what the model wordings mean and that enables clear communication between them. To take away the terms of this language would be to take away the ability to negotiate efficiently.

To lose the availability of the model wordings would also slow down dramatically the process of contract formation. A great deal of effort has been made in recent times by the London Market and the FSA (the UK supervisor) to speed up the process of contract formation, so as to ensure contract certainty, by which is meant that wordings must be fully agreed on the day when the policy incepts. If selections of wordings were not available in ready-made model form, that goal would be very hard to achieve.

It should also be noted that model wordings facilitate access to the market for new entrants. The availability of an array of well understood clauses with which the brokers and clients are familiar enables underwriters to establish themselves without creating a large legal apparatus.

### 3.1.2 Maintaining the block exemption on “standard policy conditions”

It is apparent that the block exemption on “standard policy conditions” provides the industry with a necessary degree of legal clarity to continue this valuable liaison provided of course that the requirements of the block exemption are always fully met. Please note that despite the language in the block exemption we prefer to use the term “model wordings” not “standard policy conditions”.

Given the vital nature of the model wordings to the insurance industry in its daily work and the potential cost of uncertainty, it is important to our members that they can be assured that the drafting of and use of model wordings is, and will remain, recognised as permitted. We would therefore strongly urge the EC Commission to maintain the present block exemption on standard policy conditions.

## **3.2 Block Exemptions: Pools**

While the London Company Market is mainly comprised of individual subscription-based operators, as described above, there are also certain group arrangements, which would fall under the pooling consideration.

The IUA is aware that there may at any time be a number of other group arrangements between market participants. These may range from agreements that an underwriter can act on behalf of others, to more formal arrangements to underwrite certain types of risks as a pool. Generally in Europe pools have been comprised of various national companies who come together to conduct specialist business that is indigenous to their country or state and which did not make economic sense for all companies to handle individually. Nuclear risks would be an example of this.

We do not have exhaustive data concerning the many complex activities of this type within the market, because as an association we are not involved in their administration. We do, however, organise Market Briefings (training seminars) to encourage our members to remain fully aware of the competition requirements under European and UK law.

Pools save expenditure through rationalisation of administration expenses and provide a focus of specialist expertise.

Pools also fill gaps in the industry which might not otherwise be covered, because no individual company is sufficiently well capitalised or diversified to cover the risks. The more mature marketplaces tend to have developed pools to cover this type of risk, but in some cases the sheer size of the risks is such that they can only be covered by international pools.

We welcomed the extension, introduced as part of the last revision to the block exemption, of the thresholds for insurance and reinsurance pools. It seemed appropriate, given that globalisation and mergers and acquisitions are likely to continue to follow present trends, leading to a progressively smaller number of participants competing in an increasingly global market place. The new higher thresholds should enable groups of smaller and medium-sized insurers and reinsurers to provide more serious competition to the largest companies.

To sum up, we believe that insurance and reinsurance pools have a useful, and, in some cases, essential, role to play in covering large and difficult risks. They also enable smaller undertakings to compete for business which would otherwise be closed to all except the largest undertakings. We would very much recommend that the block exemption for pools should be maintained.

### **3.3 Block Exemptions: Sharing of Data**

Paragraph 3.2.3 of Part III of the Interim Report states that “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”.

Usable information of that kind is often available only to the largest insurers or reinsurers, or to those with records going back for many years. It can, therefore, be extremely helpful, if not essential, to other companies when there are agreements to pool information and to generate statistics that can then be made available to the market as a whole. Such agreements are more frequent in the more mature and efficient market places.

The advantages to the smaller undertakings and to foreign undertakings trading cross border are clear. Larger companies can also benefit from data that is more refined and accurate than their own, or which fills gaps in areas where they have poor information.

Better data can also assist the Supervisors in evaluating the security of companies that they regulate. Solvency II will bring in a new regulatory environment where there will be tighter evaluation of risks and matching of capital to exposures. More and better data may well be required in many cases, and there will be pressure on the insurance industry to co-operate in providing this to regulators and customers.

For these reasons, it seems to us that the arguments for maintaining the block exemption on sharing of data appear to us to be very strong.

## **4. Uninsurability**

### 4.1 Uninsurable risks

The EC Commission is questioning how the insurance industry decides whether or not to cover certain risks, and why it may appear sometimes that there has been a collective decision not to do so. The industry does not decide; individual companies decide. Common features will sometimes emerge but that is obvious when different players are active in the same or similar lines of business. Threats of unquantifiable risk or uncontrolled accumulation will often give rise to independent but similar actions and responses from insurers. Generally insurers make their profits from accepting premiums to cover as many and varied risks as possible and as is permitted by their licence. In normal circumstances, their appetite to cover any risk is only constrained by probity, prudence and the duty to policyholders and shareholders. They will refuse to offer cover, or withdraw cover, only if they are not in a position to insure the risk. That may be because the risk is simply unquantifiable, or it may be because the insurer does not have the financial strength or the expertise required to cover it. In a co-insurance environment because there are several insurers participating on a single risk this gives rise to one overall policy written to give identical cover from all insurers so that the client knows his risk is properly and confidently insured. Some exclusions therefore are common to all players on a single cover.

If a risk can be covered at all, it would be unusual for one entity or another not to work out how it can be done, and to create a product or indeed a whole new vehicle for the purpose of doing so.

A risk would be more difficult to insure when the cost of covering it cannot be reasonably quantified and/or foreseen. This is similar to the situation where a manufacturer refuses to sell, or withdraws, a product whose potential dangers to its users cannot be evaluated. A company should not sell products which do not work, or which could create liabilities that it may not be able to meet.

Moreover, insurance supervisors require insurers to ensure that they have adequate funds to cover all the risks that they accept. If they cannot show that their funds match their risks, then the supervisors will impose high capital requirements, and may even withdraw the insurer's permission to trade.

As noted above in the context of the sharing of data, Solvency II will increase the focus of regulators on the ability of insurers to meet their liabilities. It will also place

greater direct responsibility on senior management of insurers and reinsurers to ensure that all liabilities are fully assessed and financially covered.

#### 4.2 Government-backed pools

In some cases where risks are uninsurable, governments have created private-sector insurance or reinsurance pools that are supported by government guarantees to pay for losses above a certain threshold. As is noted in paragraph 5.4 of the Interim Report, the liabilities covered include terrorism, nuclear and environmental risks. In our view, such arrangements are generally helpful, provided that they are designed to back up the private sector, without unduly interfering in the market place and preventing it from developing its own solutions to gaps in cover. When such schemes are well designed, they can help create and sustain a market which would not otherwise exist. Such, for example, is the case of Pool Re, which provides the essential support needed for terrorism cover against property damage in London and the UK. Pool Re and similar arrangements in other countries are not covered by the block exemption and can exist only thanks to special dispensations from the national and European competition authorities. We are in no doubt that these dispensations should be maintained for as long as the need for them remains and greatly facilitates commerce in applicable EU territories.

### **5. Intermediaries and disclosure**

Our comments on the Interim Report's findings about the distribution of insurance services through intermediary networks relate to the question of comprehensive disclosure of remuneration.

In the London Market, the broker is exclusively the agent of the insured, and the IUA has put it clearly on record that it believes that there should be full disclosure of all remuneration received by brokers both directly and indirectly to their clients. In recognising that the broker is the agent of the policyholder, disclosure of all payments is the only reasonable way to manage and minimise any possible conflicts of interest. All fees and commission must be transparent and open to present the best opportunity for an agent to demonstrate value to his principal. Direct fees or commissions can sometimes be supplemented with performance fees or profit commissions or contingent commissions which are linked to either a single risk or the results of a portfolio of risks. All clients should know of the existence of such arrangements.

IUA recently conducted a survey of clients' understanding and experiences in this area. A copy is attached for information.

## 6. Best Terms and Conditions

The Interim Report questions the insertion of “best terms and conditions” clauses and other similar wordings in some reinsurance contracts.

We have taken note of the potentially negative aspects of the use of the clause identified by the EC Commission and set out in the Interim Report.

## 7. Profitability

We would like to comment on the issues raised by the Interim Report in relation to the profitability of the SME sector and the large corporate sector.

Section 4 (SMEs versus Large Corporate clients) of Part VI (Financial Aspects of the Industry) of the Interim Report draws conclusions from Figure VI.8 regarding the patterns in Member States for the differential weighted combined ratio of SMEs versus large clients. Some countries are said to have consistently high combined ratios for SMEs and others consistently low combined ratios, with a third group showing high levels of divergence from year to year.

Our reading of Figure VI.8 does not lead us to believe that there is a significant problem in the differential for Europe as a whole. We note that over the period of six years in question (2000-2005), there was a high level of fluctuation across the line of zero in the combined ratio differential in each of the six largest non-life insurance markets (DE swing over 40%; ES swing nearly 50%; FR swing over 15%; IT swing about 20%; NL swing over 40%; and UK swing over 30%). Given that these countries make up the bulk of the European insurance industry and that several of them are shown by the Inquiry to be among the most efficient and competitive, it does not appear to us that a pan-European problem has been identified here.

For some of the smaller Member States, where there appear to have been consistently higher or lower combined ratios, the explanation may not necessarily lie in a competitive imbalance. There may well be local historical factors in play. In particular, it seems likely that the patterns within the new entrants to the European Union can be explained by the “dead hand” of the state insurance monopolies of the past, the relative immaturity of the new private sector, and rapid growth in the insurance industry and in the economy as a whole. Much change, and many fluctuations in patterns are to be expected in the future.

Moreover, there are inherent dangers in attempting to draw conclusions from the past six years, or indeed from just one year, 2005, as the Interim Report does in several places. In many ways, the past six years have been exceptional, with a number of unusual catastrophic events and very erratic behaviour in the markets.

In order to draw working conclusions about an inherent flaw in market competitiveness, it would be necessary to compare data from a longer period (provided it was available).

## **8. Demand-side substitutability**

The Interim Report suggests that the tendency among cedants to select only highly rated reinsurers may have an effect on the substitutability of reinsurers. In other terms, are there enough solvent reinsurers to supply the market in a competitive manner?

It is true that cedants will in certain circumstances tend to favour reinsurers with higher ratings. This is hardly surprising and emulates patterns in other sectors of the financial markets where for example consumers might wish to have their pensions placed with the most highly rated companies. Credit rating agencies have grown in stature and maturity and aim to provide an independent analysis of a company's financial strength and/or claims paying ability. However, it is also true that in the situations where a company is downgraded to a level perceived to be more 'at risk' it can materially affect the fate of even large companies. We agree that the ratings agencies have become more influential in the decision making process and that many of our members are uncomfortable with this situation.

It must also be said that in the London Market there is still a healthy number of participants, large and small, so the scope for substitution of supply is broad.

London remains a competitive market place offering customised services to meet special needs. Barriers to entry are very low in London and this is strongly evidenced by the diverse nature of the capital providers who are successfully doing business here. Moreover, we believe that new companies that are constantly emerging elsewhere in the world are always likely to set up offices here in the future because of ready access to diverse business that is efficiently conducted and well regulated.

We hope that you will find these comments useful and helpful.

Yours sincerely,

**Dave Matcham**  
**IUA Chief Executive**