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Commissioner of the European Communities
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Via Email: Comp-Ins-Inquiry-Feedback@ec.europa.eu.

Dear Sirs

Sector Inquiry in Business Insurance

Non Confidential Consultation Response

The Willis entities referenced in the Sector Inquiry into Business Insurance ("Willis") hereby respond to the Commission's invitation to industry participants to engage in dialogue on the preliminary findings contained in the European Commission's Interim Report. Although Willis concentrates in large measure upon broker-related issues highlighted by the Commission we have also sought to provide more general comment on other aspects or on related issues.

<u>Discrepancy of combined ratios</u>

Responding to the first question raised on page 148 of the Interim Report:

Q1: **Are there compelling justifications for the apparent discrepancy in the level of combined ratios of SME's and LCCs observed in some parts of the EU-25?"**

A: Willis does not have access to the financial and statistical data from which the EC in its Interim Report makes its findings. On that basis alone we are not in a position to accept the combined ratio findings, their accuracy nor the conclusions drawn. In addition, Willis, as a broker, is not in a position to comment upon insurer profitability. Subject to these caveats, there are inevitably differences between clients, the type of risk they are seeking to insure and the insurers that will insure that risk. Larger or more sophisticated clients are more likely to structure their insurance so that they retain a significant amount of risk allowing for more flexibility in terms and price. The professional skills and experience of medium, large, multi-national or global brokers, as opposed to tied or small brokers, may influence and affect terms and price due to experience and knowledge of large/medium/complex risks, resource, and geographical situation. These factors may have an impact on areas of profitability. In addition, the largest clients have the ultimate bargaining power when it comes to price, namely that they do not need to, and therefore will not, insure unless they are offered the price closest to that which they are looking for.

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Best Terms and Conditions Clauses

Responding specifically in response to the questions raised in page 148 of the Interim Report:

Q2: **"How widespread is the so-call "best terms and conditions" clause in the reinsurance and the co-insurance markets? Where does this type of clause originate?"**

A: The terms originate from insurers or reinsurers.

It is Willis' general practice across Europe to reject "best terms and conditions" clauses incorporated by insurers/reinsurers in quotes, by way of subjectivities on slips or within proposed/final terms. As a consequence we have seen a reduction in the number of insurers/reinsurers seeking to impose these clauses, although endeavours by (re)insurers to incorporate them have not been completely eradicated. From a European perspective attempts tend to emanate from continental European reinsurers. By way of example, in the past few months in multi-national facultative reinsurance renewals a number of continental European reinsurers have included the words "best terms and conditions" in quote sheets. The clauses have been rejected and removed from slips.

We understand other brokers may well continue to see routine attempts by (re)insurers to include this type of term.

Q3: **"At what stage in negotiation does this type of clause appear and which/how many participants ask for its introduction?"**

A: They tend to appear within a quote sheet or as a subjectivity on the slip often next to the (re)insurer's stamp. The number of participants asking for its introduction varies.

Q4: **"How is the clause enforced?"**

A: This type of clause contained in (re)insurance contracts can allow (re)insurers to benefit to the detriment of the client through the imposition of the most restrictive terms at the highest price. They might perhaps be described as "worst terms for insureds" for the following reasons:

- (re)insurers who contract on a "best terms" basis create, as opposed to eradicate, ambiguity. These clauses are the antithesis of contract certainty. By way of specific example if a "best terms" clause applies within an insurance contract a client will not know in advance what claims notifications terms and conditions it has to satisfy in the event of a claim or occurrence. As a result it may find itself in breach of a condition precedent in respect of time required for/method of notifying a claim or a circumstance, breach of which might allow an insurer to avoid liability for the claim in question.

- The effect of such clauses is one of underwriting after the event, most typically when a claim or potential loss arises. (Re)insurers with a "best terms" clause will be free, after the event, to pick and choose the terms and conditions stipulated by their co-(re)insurers that most favour them in the particular circumstances to the ultimate detriment of the (re)insured client (see claims notification example above).

- In relation to premium they may result in the imposition of the highest premium.

The clauses tend to be worded along the following lines "best terms and conditions", "best terms as to exclusions", "warranted highest paid terms". Lengthier clauses have been seen but these tend to emanate from the US and Bermudan markets.

Q5: **"What is the effect of this type of clause on the market?"**

A: See answer to Q4 above.

Long-term agreements

Responding briefly to the questions on page 148 of the Interim Report:

Q6: **"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."**

A: The issue of barriers to entry for insurers requires a response by insurers.

Q7: **"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."**

A: From an independent broker perspective long term insurance contracts and tied agencies, particularly within Italy, may have historically made competition difficult as they have prevented switching and thus the winning of new business away from other brokers/agents, but we are not aware of there having been serious obstacles.

Of course some insurance clients seek longer term contracts e.g. 2-3 years for continuity and price certainty. Longer term insurances also require less work for insured clients than an annual insurance contract which requires annual renewal negotiation.

Intermediaries' remuneration

Responding specifically to the questions on page 148, and more generally to findings in the Report and comments by stakeholders since its publication:

Q8: **"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?"**

A: On the issue of transparency and disclosure to insurance clients Willis sees no reasonable ground for distinguishing between agents and brokers. To create a truly competitive distribution market and level playing field all insurance intermediaries including agents should be equally transparent to their respective clients/insurance purchasers.

We cannot talk to the practices of all brokers, but our general experience of other brokers and agents across Europe is that there is a lack of disclosure and transparency regarding amount and source of remuneration. There was apparently little public support at the hearing in Brussels on 9th February for the implementation of full disclosure and transparency to insurance clients, which begs the question why? Some attendees suggested that clients, particularly SME's, are simply not interested in a broker or agent's commission and are only interested in the overall cost of the product and service. It is difficult to understand how a client can compare the overall cost and service provided if the full cost is not disclosed by reference to a breakdown of commission, premium and contingent commission as well as information about the insurance itself. If there is no spontaneous disclosure and transparency of both source and levels of remuneration a client is not able to make a fully informed decision on the insurance cover recommended or its price. Moreover, the client is not exercising a fully informed choice if the broker or agent does not disclose contingent revenues it is receiving from the insurer whose cover it is recommending.

It has been suggested by opponents of disclosure and transparency that large brokerage firms are calling for net quoting as they are not remunerated on a commission basis. This is absolutely not correct and larger brokers are still remunerated on a commission basis subject to client choice and/or law and practice. Willis firmly believes that remuneration is a matter of client and broker choice based on mutual agreement, and that it should remain so. Disclosure of what the broker receives assists this process.

It is Willis' experience that many clients including both SME's and large/multi-national clients prefer remuneration by way of commission for insurance placements. Remuneration by commission is simple, easily understood, it requires less resource and time than is needed to negotiate annual fee-agreements, and, where multi-national cover is arranged for subsidiaries by parent companies, it is often said by parent company clients to be easier for them as they simply need to apportion the cost of insurance to each subsidiary by reference to the premium and commission. Multi-national brokers access insurance markets around the world and so are able to offer a wide range of strategic, operational, risk management and insurance solutions across all industries, whether within a limited region, within one particular country or over several continents. This can mean that lower premiums and lower commissions are paid. If brokers and agents disclose commission to the insured the amount is capable of acceptance or further negotiation by the client.

With respect to net-quoting, it appears that the net-quoting currently seen in Finland, Sweden and Denmark is a mechanism that may allow for the control of distribution by insurers within the relevant domestic market and restrict competition from international insurers. The market practice and/or law in these Member States prevents acceptance of commission by brokers thereby requiring payment of independent brokers to be by way of fee. This removes from the client the commercial right to choose how its broker will be paid for services.

Additionally, it does not appear that this practice always results in the premium being reduced by the full amount of the commission that the insurer has avoided paying. By way of example, the price of a liability policy in one Nordic country remained the same post the net quoting regime as it did when the price included commission. In the same country, attempts have been made to increase premiums following the netting of the rate for no apparent reason. The position in these Member States has the potential for foreclosure of the market to independent brokers and an increase in cost of insurance to insurance clients.

As the premium element of insurance has not always been reduced commensurately by insurers by the amount of commission that was paid there may be an economic disincentive on the part of purchasers/clients to use independent brokers now charging a fee for the broking services provided (including the canvassing of more than one insurer and the provision of information and advice on cover being offered). This may have the effect of preventing true competition between agents and independent brokers. While brokers need to be remunerated by fees, agents and multiple agents i.e. those tied to insurers, may receive commission and contingent commission. Not only can these agents receive commission from the insurer, we understand they have no obligation to disclose their remuneration.

Difficulties are also experienced by brokers in Germany with some direct insurers simply refusing to deal with brokers, or, refusing to pay commission and at the same time refusing to net quote. This has the potential to foreclose the market to brokers.

Commission Rebating

In response to the questions at page 148:

Q9: **"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?"**

A: Rebating of commission by independent brokers to their clients is prohibited in Germany, but the legal or moral justification for this is not clear particularly given that German in-house brokers (owned by non-broking corporations) are able to grant commission rebates and so can pass the benefit on to their internal group client, whereas independent brokers cannot offer the same benefit to their independent clients.

Other than the above, to the best of our knowledge, brokers may rebate commission to clients although it is entirely dependent upon commercial negotiation and agreement between the broker and the client. This is the case whether the client is an SME or an LCC. Willis discloses its commission pre-placement so it is open to all clients to discuss the commission amount, the value added and service provided by Willis and, if appropriate, a potential rebate.

Q10: **"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?"**

A: We are not aware of any such practices or agreements.

Horizontal Co-operation

In response to the questions at page 149:

Q11: **"The Inquiry's data concerning the various forms of co-operation among insurers shows substantial differences among Member States. How can these differences be explained?"**

A: This question is a matter for insurers.

Q12: **"Which sorts of benefits have you experienced, as a business insurance customer, from the forms of co-operation among insurers described in the present Report?"**

A: Willis broadly supports the comments made on behalf of DVS at the Public Hearing in Brussels on 9th February 2007. Willis also recognises that pools are created to cover what are primarily catastrophic risks such as terrorism, nuclear and natural catastrophes for which clients might otherwise be unable to obtain cover. It is crucial that the European insurance market be in a position to continue to provide capacity and availability of cover for such risks if the European insurance market is to remain a significant provider of business insurance to global buyers.

Willis also found the insurer arguments in support of sharing of data and statistics to be compelling. Willis recognises that smaller insurers or insurers in "emerging" markets may not have the resource, experience or funds to capture, collate and read statistical data thereby enabling them to set rates by reference to risk assessment. To the extent larger insurers or associations in Member States do collate such information it strikes us to be sensible and prudent that they either (a) share it without discrimination to allow other insurers to independently assess their rating risks or (b) do not share it at all.

Q13: **"As a business insurance customer, have you ever experienced that the forms of co-operation among insurers described in the present Report were hindering competition?"**

A: Again, we found the comments made on behalf of DVS to be persuasive particularly in relation to co-operation over standard common <u>non-binding</u> conditions. It was recognised that on the one hand they may be of benefit in that they facilitate competition by integrating positive elements into wordings, yet at the same time they are capable of being a hindrance in that they may influence the use of restrictive or exclusionary terms.

Clearly the achievement of contract certainty can be facilitated by the use of precedent or model clauses or wordings that can be adapted and amended for different clients needs. Access to databases of draft/model clauses and/or wordings is valuable. It enables brokers and insurers to obtain a base from which to draft a bespoke contract which leads to contract negotiation between client, broker and insurer, from which can follow amendment, further discussion and ultimately a bespoke policy.

To the extent the EC is questioning the continued existence of the Insurance Block Exemption Willis believes any withdrawal or amendment should be considered in depth with a full analysis of the practical ramifications on the European insurance market in the context of its role as a global provider of insurance and reinsurance.

We comment on the subject of co-insurance at pages 9 and 10.

<u>GENERAL POINTS</u>

<u>Conflicts of Interest</u>

It is said in the Report at page 129 that "Obvious conflicts of interest arise where intermediaries provide underwriting services to insurers in respect of the intermediaries' own insurance placement clients."

Although Willis accepts there is potential for conflicts arising in this situation we do not agree that they do arise in all situations.

A broker may undertake services and tasks acting both as an agent for the insurance client and as agent for the insurer, for example where the broker operates a binding authority, or in the role of managing a specific underwriting programme or Managing General Agency. These facilities may allow the broker ("cover holder") to grant/bind cover and/or settle claims within specific authority parameters.

The operation of a binding authority or underwriting facility by a broking house can be beneficial to clients in a number of ways. These authorities or facilities allow for the aggregation of a number of small risks or specialist risks into an overall facility thereby providing individual clients with price or coverage benefits, which they would not be able to achieve in the open market on an individually brokered placement or, which they would only be able to achieve at significant cost on restricted terms. An additional benefit is that a broker is likely to be able to provide evidence of cover and contract certainty prior to inception. In certain jurisdictions this responds to important regulatory goals.

Clearly the dual role may give rise to potential conflicts of interest, but these conflicts are manageable subject to appropriate safeguards, policies and procedures being put in place to manage them. Management tools include the disclosure by the broker to the client that in operating the underwriting facility the broker is acting in a different role and on behalf of the underwriter. The broker should explain that some roles which would ordinarily be undertaken by the insurer will be undertaken on the insurer's behalf by the broker. Another conflict management tool is the disclosure of remuneration the broker is receiving from the insurer(s) as a result of operating the underwriting function, including service fees or profit commission (as applicable). In addition and in an ideal world, the underwriting element would be handled within a discrete department or unit within the broking house.

Where the broker is acting in a dual capacity, the client should be told that the broker may not canvass a wider insurer market for insurance products. To avoid potential conflicts or the suggestion of conflicts this should be disclosed to the client before placement, as should service fees or profit commission (formulae) to be received for doing so. The roles undertaken for insurers in these situations may include preparation and issue of policy documents or certificates of insurance on behalf of insurers (which ought only happen where the broker is acting in a particular role for the insurer e.g. as underwriter under a binding authority. This is distinguishable from the usual position where a broker is acting solely for an insured client and in preparing and obtaining for distribution a policy wording acts on behalf of the insured client – see below). In addition, to avoid the potential for conflicts in relation to claims handling the broker can, in the event of a disputed claim, adopt a policy of referring claims handling back to the insurer for its sole handling.

The interim report highlights a number of services which it classifies as being provided for the benefit of insurers such as policy administration and accounting services. Where Willis conducts general insurance placements on behalf of insurance clients these types of services are undertaken on behalf of and for the benefit of the insurance client and are part and parcel of the overall service offered. It would be unhelpful to abandon them. Most of our clients have neither the resources nor willingness to assume these responsibilities and thus the services are being provided ultimately for the benefit of the client rather than the insurers. In the case of policy documents, it is usual for more standardised wordings to be prepared by the insurers and checked by the brokers on behalf of their clients. For the more bespoke customised wordings the contract is often, especially in the London market, prepared by the broker and then checked by the insurers. It is a service provided to the client. This would be similar to a lawyer drafting and preparing a document for his client.

Willis adopted a policy of transparency in early 2005 and abandoned the acceptance of contingent commissions in relation to insurance placement activities. In addition, it committed itself to disclosing potential conflicts of interest (and of course actual conflicts of interest). This was a challenging experience as it involved changing and implementing many practices that have evolved over centuries.

The management of conflicts of interest involves many facets, but it is at the core of healthy management and must involve disclosure and transparency to clients. It allows for open and healthy commercial discussion, informed choices and fair decisions.

Contingent Commission

In October 2004 Willis announced that it was voluntarily abandoning the acceptance of contingent commissions from insurers in respect of worldwide insurance broking and placement activities. We sensed that clients did not like contingent commissions. They create a perception of actual potential conflicts of interests in relation to the amount and source of revenue and how that revenue may influence services being provided. We remain of that view.

We have read with interest the chapter in the Report on contingent commissions (starting page 122). The Report, at page 127, defines contingent commission as a payment where the amount payable is "based on the achievement of agreed targets". The definition of contingent commission in the Inquiry questionnaires did not include volume commission where there were no targets at all but merely an agreement to pay a further fixed agreed percentage of total premium received by insurers, usually paid later on a deferred basis. Page 132 of the Report suggests, however, that the EC believes this type of contingent payment i.e. not linked to pre-agreed targets, may give rise to a conflict of interest on the part of the intermediary and may create an incentive to steer business to particular insurers. It may give clients the potential to question the intermediary's motivation. Accordingly this type of volume contingent ought, in our opinion, to be taken into consideration by the EC to the extent it makes proposals regarding contingent payments and/or disclosure.

At an industry level we believe that those who do not receive contingents are excluded or prevented from participating in a revenue stream and so are not operating on the same playing field.

Reinsurance

We note that the focus of the Report lies in reinsurers' financial ratings and "best terms and conditions" clauses. The latter has been dealt with in the earlier part of this letter. Regarding financial rating we reaffirm the importance of financial stability and security in the insurance industry generally. The ramifications of insurer insolvency have been seen in a handful of high profile insolvencies and highlight the need for insurer financial security.

Although the Report did not deal in depth with reinsurance broking arrangements, the issue of reinsurance commission was raised by a member of the audience at the Public Hearing. With regard to treaty and facultative reinsurance it should be remembered that these contracts are undertaken between professionals within the industry (market counterparties) and the insurer and reinsurer are aware of general brokerage levels which apply. Where specific requests are made by <u>reinsureds</u> in relation to the brokerage earned on their reinsurance placements they ought to be answered.

As for the issue of reinsurance disclosure generally, financially it is the insurer, not the reinsurer, which is legally liable to the underlying insured and it is the insurer that is financially responsible for claims made by the insured. There is not a right of cut-through by the underlying insured to the reinsurer. In any event some of the contractual terms within the reinsurance will be specific to reinsurance issues and the terms on which an insurer seeks to protect its financial rating and balance sheet should be irrelevant to the insured client. The insured client ought to be satisfied with the terms and rating of its insurer such that there is no need to look beyond their own contractual relationship. The exception to this is in pure fronting or captive arrangements (see below). The majority of all reinsurance premiums transacted are transacted on reinsurance treaties. Treaty reinsurance is the reinsurance of a block of business, or whole account, for example as to class e.g. marine; peril e.g. windstorm/earthquake; geographic e.g. Asia Pacific; or a blend of two or more of these. Treaty reinsurance is therefore of no direct relevance to the underlying insurance policyholder.

Moreover, insurance contracts and reinsurance contracts (certainly under English legal principles) are two distinct contracts with different contracting parties, and brokers treat the insured and reinsured as entirely separate clients. Accordingly reinsurance contract terms are not disclosed to underlying insured clients as a broker owes duties and obligations of confidentiality to the separate reinsured client in relation to its particular contract.

The provision of reinsurance services to reinsureds involves separate services and work undertaken by the broker on behalf of the reinsured. Reinsurance remuneration and potential conflicts can be dealt with by effective management, disclosure and transparency. Willis discloses generically to underlying insurance clients the fact that it provides reinsurance broking services to insurers and that it may be paid for those services in addition to any commission received for placing the underlying insurance cover. We deviate from this where the facultative reinsurance arises because the original placement is being fronted 100% by an insurer without that insurer retaining any risk or where the insuring, and thus reinsuring, entity is a client captive/client insurance company. Here specific disclosure and disclosure of terms will be given to the insured and reinsuring client.

In the placement of facultative reinsurance placements such as the facultative reinsurance of global programmes it may be prudent - due to broker expertise and knowledge - for the same broking house involved in placing the direct insurance to be involved in placing the reinsurance, albeit it the individual brokers will not be the same. This is for the simple, sensible reason of ensuring that the reinsurer's facultative reinsurance is back to back with the underlying insurance, although while facultative reinsurance should so far as is possible be back to back with insurance there may inevitably be differences in relation to deductibles, levels of cover, law and jurisdiction and, sometimes, risks covered.

Co-Insurance

The arrangement of insurance through co-insurance has not been focussed upon in any great detail in the Interim Report. That said Willis would like to emphasise that the co-insurance market is absolutely essential for large, complex or specialist risks and it brings significant benefits to clients and the industry as a whole. Co-insurance is analogous or similar to a syndicated loan within the banking community. Co-operation between insurers in the negotiation of the insured client's cover facilitates both flexibility and breadth of coverage, competitive pricing, speed and clarity in the agreement to, and issuance of, insurance contract documents, as well as greater quality and speed in the claims process, all of which are essential to insured clients.

Co-insurance provides financial capacity for cover, allows breadth of cover and avoids market concentration in specific classes or type of risk. It also allows for the spread of financial risk amongst a number of insurers. It opens the market to less experienced or small insurers who are willing to "watch

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and learn" from more experienced insurers. By spreading rather than concentrating financial risk the client receives greater financial security on large risks and a consequence of the spreading of risk can be the reduction in price of insurance. The less capacity and appetite there is in the market for writing any given risk the higher the price of insurance will be for clients. It is a supply and demand situation. The greater the capacity and appetite for risk on a co-insurance placement, the lower the cost. If the market is incurring significant or adverse claims experiences and/or there is generally a hardening of or a hard market the risk appetite simply may not exist. In this case it may be difficult to obtain 100% cover at all (at least from financially sound/secure markets).

Negotiation of co-insurance involves negotiation by brokers with all insurers over the terms and conditions on which they are willing to underwrite. The ultimate aim is consensus (with the broker trying to obtain the widest terms available for the benefit of the client) in order to avoid the client having several different sets of contractual terms for the same risk, which can prove to be exceedingly costly and detrimental in the event of a claim. A client with co-insurance for a major property placement ultimately wants its insurers to be providing one policy wording on the widest and most beneficial terms to the insured client. Having consensus on terms with co-insurers provides that i.e. it provides contract certainty, although in certain classes of business or depending on the size of the risk and level of cover sought it is not always possible to achieve - some insurers will only write on their own terms for their share.

Negotiating the widest terms possible for the benefit of the client is the added value that an independent broker brings to the table for a client. It is the experience and skill of independent brokers that brings together a consistent and fair approach among co-insurers. Insurers will only write a risk depending on their risk appetite and in different classes of business there can be a considerable difference in premium terms offered.

The skill in broking involves attracting the optimum capacity of all the co-insurers to the broadest coverage, the highest coverage limits, the most favourable deductible structure and the most competitive premium on a broadly consensual basis whereby the client has a coherent and complimentary set of terms and conditions from all the subscribing markets at a competitive price.

Yours faithfully

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