Comments of Royal & SunAlliance on the European Commission's Interim Report in its Inquiry into the European Business Insurance Sector: Confidential Version

1. **Executive Summary**

1.1 By way of broad summary, R&SA:

(a) questions the accuracy of the Commission's financial analysis and the validity of certain conclusions (see in particular Annex A to this Submission) and considers that the European business insurance sector is particularly competitive (for the reasons set out in Annex B to this Submission);

(b) believes that the Commission's calculation of profitability in the EU is inaccurate due to the mismatch in the time periods considered for the combined ratio and the average investment income;

(c) considers that the Commission has taken an unrealistically high generic figure for net investment income, and that, further, on average commercial insurers do not enjoy pre-tax profits anywhere in the region of 26 per cent[1];

(d) disagrees with the Commission's suggestion that underwriting for SMEs is used to cross-subsidise low returns in the LCCs segment;

(e) considers that the current Block Exemption (or a revised version thereof) should be retained as co-operation between insurers in appropriate circumstances yields pro-competitive effects;

(f) in principle would support measures to introduce transparency in the distribution channel, but would observe that the underlying obligation to manage conflicts of interest arises out of the fiduciary duties owed to the client by the broker or other intermediary. It is the responsibility of the broker or intermediary to manage these conflicts (under the supervision of the appropriate financial services regulator), of which the transparency of commission payments may be only one element;

(g) notes that the UK Financial Services Authority ("**FSA**") is currently analysing the extent to which lack of transparency is leading to customer detriment or impairing market efficiency and whether mandating commission disclosure would lead to benefits that outweigh costs and intends to publish the results of its analysis in Q4 2007. R&SA understands that financial services regulators in other Member States (e.g. Ireland) may be examining similar issues. Accordingly, R&SA would suggest that the Commission ensure that any recommendations contained in its final report and the timing of any actions are consistent with these initiatives; and

(h) considers that a move towards transparency could deliver unintended consequences such that brokers and other intermediaries might conclude that it is no longer cost-effective to provide current levels of advice to the SME sector going forward. As is explained in further detail below, the risk is that any reduction in the number of available brokers will reduce the pool of insurers to which the SME sector has access.

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[1] *[Business secrets]*.

2. Background

2.1 The European Commission (the "**Commission**") has extended an invitation to industry participants to submit their views and comments on the Commission's interim report in its inquiry into the European business insurance sector ("**Interim Report**"). Royal & SunAlliance ("**R&SA**") welcomes this opportunity.

2.2 R&SA has endeavoured to provide feedback on the Commission's conclusions on (a) financial aspects of the business insurance sector; (b) duration of contracts; (c) reinsurance; (d) structure, function and remuneration of distribution channels; and (d) horizontal co-operation among insurers. In addition, R&SA has provided additional comment on the methodology used by the Commission in conducting its financial analysis (which is attached as Annex A to this response), on competitive conditions in the European market for business insurance (Annex B) and R&SA's response to the Commission's issues for consultation (Annex C). (This document including the Annexes are referred to together as the **"Submission"**).

2.3 R&SA considers that the European business insurance market is very competitive and, in particular, that the largest non-life insurance markets in the EU are all unconcentrated and that barriers to entry are low. The competitive environment in the EU is more particularly described in Annex B to this Submission.

2.4 *[Business secrets]*.

2.5 R&SA also notes the comments of Mr Phillip Lowe at the Commission's Public Hearing on 9 February that Mr Lowe was concerned that horizontal cooperation between insurers may lead to the withdrawal of business insurance cover to certain SMEs. R&SA considers that there is no evidence to support such a contention. R&SA understands that the example that Mr Lowe was referring to related to mandatory decennial insurance in France and in particular the use of certain materials in construction. It was noted that insurance was not easily available for these risks. In R&SA's experience, there is no "cooperation" by insurers to deny cover to certain SMEs. Risks that are new or use unproved materials or technology require specialist knowledge and skills and may be unattractive to insurers because of the inherent uncertainty of risk. However the dynamic nature of the insurance market means that entrepreneurial solutions will typically be found in such cases.

2.6 In view of the commercially sensitive nature of R&SA's response, R&SA has also submitted a non-confidential version which may be published by the Commission.

3. Financial aspects of the business insurance sector

The Commission's profitability analysis

3.1 The Commission concludes that "*profitability is high in business insurance*" and that "*profitability has been sustained over time in most Member States*". R&SA considers these conclusions to be inaccurate for a number of reasons, namely:

(a) the business insurance cycle is longer than the five-year time period considered in the Commission's analysis. Over a longer and normal insurance cycle, R&SA would expect the data to demonstrate that the business insurance market has experienced periods of losses, insolvencies and lower levels of profitability. In particular, R&SA would note that there has also been a reduced frequency and severity of weather losses in Europe during the last five years;

(b) the Commission's calculation of profitability in the EU is inaccurate due to the mismatch in the time period considered. In particular, the Commission refers to a figure for the year 2005 and concludes that "*the aggregated item "Total commercial non-life business" displays a weighted combined ratio of 91%*", but then contrasts this with returns achieved by non-life insurance as a whole for the period 1994 to 2004, to conclude that "*business insurance is a profitable activity in the EU with a pre-tax average profit margin of 25%*". However, the figure of 91 per cent relates only to the year 2005, whilst the average investment income with which it is contrasted is taken from the Swiss Re report covering the period 1994-2004. The correct figure in the Commission's interim report for comparative purposes was the combined ratio for commercial non-life as an average for the period 2000-2005, which records a ratio of 99 per cent, rather than 91 per cent which relates just to 2005. In other words, the Commission has taken a one-off figure for a profitable year – which does not reflect the five year average – and concluded that business insurance displays exceptional profitability. This methodology is internally inconsistent and has produced an incorrect and potentially misleading conclusion. It is unsurprising that the profit margin calculated on this basis is significantly higher than the average margins experienced by commercial insurers;[2]

(c) it is not clear how the investment income figure derived from the Swiss Re report has been calculated. R&SA considers that the figure could be misleading as it may include investment income earned on shareholders' funds. R&SA believes that such income should be excluded from the profitability analysis as it represents the returns to investors who provide the mandatory capital which insurers must hold in reserve. Undertakings underwriting business insurance would typically have their "Technical Reserves" (reserves held to pay claims already notified and claims incurred but not reported) invested in liquid assets such as bonds to match their assets closely with liabilities and these would produce a much lower level of investment income in the current investment climate. Further, at least some of the investment income would be used to offset claims inflation between the notification of a claim and its eventual settlement;

(d) there are differences in the dynamics of the insurance cycle (as well as geographic differences) which affect different lines of insurance. In addition, certain lines of insurance, such as cover for environmental liability, are at different stages of the product development cycle. In this connection, any calculation of the ultimate cost of environmental liability claims is subject to a range of uncertainties that is generally greater than those encountered for other classes of insurance business. As a result it is not possible to determine the future development of environmental liability claims with the same degree of reliability as with other types of claims. Accordingly, averaging profitability across all lines of business insurance gives a distorted picture;

(e) Annex A also sets out a number of further important reasons why R&SA would question the validity of the Commission's analysis and conclusions relating to profitability. Accordingly, R&SA believes that the Commission should not take steps or make recommendations on the basis of its profitability analysis; and

(f) in any event, profitability is not a reliable measure of market power as there are many difficulties in terms of measurement, interpretation, allocation of costs and benchmarking. More traditional measures of market power such as market shares, levels of concentration and barriers to entry all show that there is an absence of market power in the business insurance market.

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2 *[Business secrets]*.

Discrepancy of combined ratios

3.2 The Commission concludes from its analysis that in some Member States underwriting for SMEs is used to cross-subsidise low returns in the LCC segment. R&SA considers the Commission's conclusions in this area to be speculative for a number of reasons, namely:

(a) there is no consistent pattern between Member States. The Commission's analysis shows that profitability for SMEs is lower than for LCCs in some Member States, whilst it is higher in others. This does not provide any clear evidence that cross-subsidisation is taking place;

(b) *[Business secrets].* There is a greater wealth of information for insurers regarding the risks facing SMEs, which makes it easier to predict the likely level of losses, whereas, LCC risks exhibit greater volatility, not least because LCC's typically retain all or more of their predictable risks within their in-house "captive" insurance operations. By their very nature the non-retained risks are unpredictable, and are likely to involve more severe losses should they arise;

[Business secrets]

(c) LCCs are generally sophisticated buyers who best understand their risks and who are aware of the alternative options they can use (including self insurance and other risk management techniques). They will tend only to place the risks with insurers that they are not content to insure themselves or where they cannot find a cheaper alternative i.e. in the financial markets. For example, they tend to self-insure the high frequency/low severity risks themselves either through simply retaining these risks or financing them through their own "captive" insurance company;

(d) for cross-subsidisation to occur, insurance providers must have market power in relation to the provision of insurance to SMEs so as to offset losses/lower prices to LCCs. The Commission's analysis provides no evidence that this is the case;

(e) there is a plethora of brokers, other intermediaries (such as banks) and insurance undertakings selling insurance to SMEs and barriers to entry are low. Such factors indicate that the market for the supply of insurance to SMEs is unconcentrated and extremely competitive. In addition, any excessive returns (if they were to exist) would be quickly competed away; and

(f) *[Business secrets]*

4. Duration of contracts in the business insurance sector

4.1 The Commission has indicated that the use of annual contracts is a common practice in a number of Member States but that contracts of longer duration are still frequently used in a few Member States. In this connection, the Commission notes that "long-term agreements" (which are not defined but presumably cover multi-annual contracts) between insurers and their customers could raise competition concerns related to the risk of foreclosure of the relevant insurance markets to new entrants.

4.2 However, the Commission acknowledges that its analysis does not purport to identify the existence of restrictions of competition in particular insurance markets and merely identifies certain issues that should be taken into account when assessing competition concerns raised by long-term agreements in the insurance sector.

4.3 R&SA's experience is that the majority of insurance contracts proceed by way of one year terms. Where multi-year contracts are used, R&SA considers that such contracts usually come into existence at the request of the client, a broker or other intermediary (for example, with construction risks the contractor will often seek a contract of insurance to cover the duration of the construction project) and typically have break clauses.

4.4 The Commission indicates that long-term agreements are common practice in some Member States such as, *inter alia*, Italy. R&SA understands that long-term agreements in Italy are driven primarily by the requirements of lending institutions in order to protect the asset they are making a loan against. R&SA understands that the Italian legislature has recently passed a law which enables insureds to cancel a long-term agreement without penalty upon providing sixty days notice to the insurer; moreover, R&SA understands that exclusivity arrangements between insurers and intermediaries will be prohibited from 1 January 2008.

4.5 R&SA notes that both the Commission's Insurance Block Exemption and the Vertical Agreements Block Exemption permit agreements with a duration of more than one year in the business insurance sector, provided certain market share thresholds are satisfied.

4.6 In addition, the existence of long-term agreements (or at least multi-annual contracts) does not automatically equate to market foreclosure. Access by a new entrant to a customer on a longer-term basis could contribute to the continued operation and viability of the new entrant to the market.

4.7 R&SA would have no objection to brokers and other intermediaries seeking the option of having multi-year contracts for their clients and further considers that multi-year contracts enable the insurer to build up a knowledge base of the risk profile and specific requirements of individual customers and, accordingly, to provide a more tailored service to the insured's individual needs. Multi-year contracts may also facilitate investment by the insured in enhanced security and health and safety measures, in the knowledge that premiums will reduce to reflect these investments over the duration of the contract.

5. Reinsurance

5.1 The Commission has raised the concern that because insurers take into account the financial rating of reinsurers, in the event of a downgrading of several reinsurers 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*".

5.2 The Commission observed that a material proportion of reinsurers hold credit ratings that are too low for them to be used by over half of the surveyed insurers, and suggests that this may indicate that there is not enough capacity in the market for the supply of reinsurance. The availability of a dynamic and secure market for the supply of reinsurance forms an important aspect of the ability of an insurer to diversify risk on behalf of the insured. If the security of reinsurers was compromised and there was a lack of supply of suitably rated reinsurers, the most likely scenario is that primary insurers would restrict their capacity for risk. Accordingly, R&SA welcomes steps to preserve the vitality of competition amongst reinsurers.

5.3 R&SA's experience across a wide range of segments and territories is that credit ratings are one element in the decision making process. It is not R&SA's experience that the LCC segment suffers inadequate capacity. Indeed, recently, the industry has witnessed a large amount of capacity entering into the market from Bermuda. Adequate premiums will always attract sufficient capacity. The exception might be very specialist areas like products liability for pharmaceutical companies.

6. Structure, function and remuneration of distribution channels

6.1 The Commission raises concerns about what it sees as the lack of transparency of intermediaries' remuneration and further that intermediaries across the EU tend not to declare to their clients how they are remunerated for the placement of insurance.

6.2 The intermediary channel plays an important role in the distribution of insurance products permitting, in particular, clients to take advantage of the expertise, bargaining power, access to a wide selection of insurers and additional services (such as risk assessment and product design) offered by intermediaries. R&SA notes the Commission's observations that competitive vitality for the supply of insurance products may well be higher in those markets where a strong intermediary channel is present.

6.3 Commission arrangements can form a legitimate means of incentivising the intermediary supply channel which, when implemented in a manner which permits the insured to make informed choices, has pro-competitive effects in the manner and quality of insurance services delivered.

6.4 R&SA understands (based on the comments of the SME representative at the Public Hearing on 9 February) that SME clients are more concerned with the premium to be paid rather than the amount of commission that brokers or other intermediaries receive. Accordingly, it would appear that SME clients value the services provided by brokers and other intermediaries highly and tend to be content to view the insurance cover and expertise provided when insurance is purchased through a broker as a single package where price is compared with other such offerings across the market.

6.5 R&SA believes that the obligation to manage conflicts of interest arises out of the fiduciary duties owed to the client by the broker or other intermediary. It is the responsibility of the broker or intermediary to manage these conflicts, of which the transparency of commission payments may be only one element;

6.6 R&SA would, in principle, support measures to introduce transparency in the distribution channel but notes that brokers and intermediaries (rather than insurers) are responsible for managing potential conflicts of interest (including the transparency of commission payments) under the supervision of the appropriate financial services regulator.

6.7 However, R&SA considers that a move towards transparency could deliver unintended consequences such that brokers and other intermediaries might conclude that it is no longer cost-effective to provide current levels of advice to the SME sector going forward. In this connection, in the UK the demands of the SME sector can vary widely and while some risks will be relatively straightforward, others will be more complex and will require the dedication of greater resources by brokers and other intermediaries. R&SA believes that these potential unintended consequences should be carefully evaluated before any changes are introduced. The likely effect of any reduction in the number of brokers and other intermediaries providing services to insureds will be to reduce the size of the pool of insurers available to the SME sector. Brokers provide a valuable service to SMEs in securing cover for risks with insurers who, in the absence of the services provided by the broker (providing relevant information concerning the details and nature of the risk), would not be prepared to provide cover. These services are of particular importance in respect of small or complex risks where the available pool of insurers prepared or, indeed, able (in the absence of specialist expertise) to deal with such risks may be limited.

6.8 It is important to ensure that any new requirement for greater transparency should be introduced in a way that is consistent with regulation by the relevant national financial supervisory authorities. In this connection, in the UK the FSA is currently analysing the extent to which lack of transparency is leading to customer detriment or impairing market efficiency and whether mandating commission disclosure would lead to benefits that outweigh the costs. The FSA will publish the results of the analysis in Q4 07 and will consider regulatory intervention if both the market failure analysis and the cost benefit tests are met and the market has not proposed its own solution by then. R&SA understands that financial services regulators in other Member States (e.g. Ireland) may be examining similar issues.

6.9 With regard to the question of broader conflicts of interest, the FSA already requires intermediaries to manage conflicts of interest fairly both between itself and its customers and between a customer and another client (Principle 8). It also requires firms to pay due regard to the interests of its customers and to treat them fairly (Principle 6) . In addition, the Insurance Conduct of Business ("**ICOB**") rules, which implements EU legislation set out in the Insurance Mediation Directive and the Distance Marketing Directive precludes the offering, giving, soliciting or acceptance of any inducement that is likely to conflict to a material extent with the duty a firm owes to it customers. In short, therefore, there are already legal protections in place in the context of intermediaries' obligations to their clients, the insureds.

6.10 R&SA's terms with intermediaries in the UK presently require the intermediary to disclose its terms of remuneration to the client if requested. This is also consistent with the requirement set out in section 4.6 of the ICOB rules for an insurance intermediary to disclose commission promptly on request from a commercial customer.

6.11 The Commission indicates that the banning of commission rebating by insurers could amount to resale price maintenance and could therefore amount to a non-exemptable restriction of competition. R&SA does not prohibit the rebating of commissions by brokers and other intermediaries.

7. Horizontal cooperation among insurers

7.1 The Commission states that "*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 current insurance Block Exemption*".

7.2 R&SA considers that cooperation between insurers to an appropriate degree and in the proper context yields pro-competitive effects. For example, cooperation by insurers on calculations and studies, technical specifications and the establishment of model policy wordings bring a deeper understanding for all market participants and can thereby facilitate market entry by small or new insurers and, in the case of model policy wordings, can be used by business clients as a benchmark to compare insurance policies offered by different insurers.

7.3 R&SA understands that the Commission will commence consultation on the future of the Insurance Block Exemption in or around 2008. The Commission has questioned the need for the continued operation of the Block Exemption.

7.4 R&SA would strongly advocate the continued operation of the Block Exemption or a revised version thereof. The Block Exemption provides important pan–European guidance both to national competition authorities and to national courts. Removing the Block Exemption would risk the competition rules being applied inconsistently across the 27 Member States.

7.5 It also provides essential guidance to potential new entrants and/or less well resourced insurers seeking to access existing or developing markets. This is important, particularly when set against the background of the recent round of EC accessions and in light of the fact that the Commission has opined that it considers insurance markets to be fragmented along national lines – fragmentation which can only increase if potential new entrants lack adequate guidance on the operation of the markets they are seeking to enter.

7.6 On model policy wordings, R&SA would observe that its policy is generally to draw upon its own library of policy wordings and, further, R&SA is not aware of any associations operating in its national markets which make the use of model policy wordings a requirement for operation in the national market concerned. In addition, model policy wordings are generally pro-competitive in facilitating market entry into new national markets or business lines by, in particular, insurers with insufficient scale or historic expertise to underwrite business without access to this resource. Similar comments can be made about the use of average risk tables and the establishment of technical specifications/codes of practice on safety devices.

8. Co-insurance

8.1 The co-insuring of certain risks is, in R&SA's experience, a responsible and prudent risk mitigation practice. R&SA would agree with the comments of Thomas Steffen of CEIOPS at the Public Hearing when Mr Steffen stated:

> *"It may not be obvious, but the sharing of certain risks or certain functions, might be highly responsible and prudent risk-mitigation practice by insurers. Supervisors could be pleased to see it."*

8.2 Insurers are concerned to maintain an acceptable spread of risk and exposure to reduce the volatility associated with large single losses or aggregations of losses which could threaten their solvency.

8.3 Co-insurance puts insurers in a position to offer cover for risks which might be impossible or commercially unviable for a single insurer to underwrite alone (either because, for example, the risk is too large, is a new risk or an old risk which has become more complex) and, as such, serves to facilitate the ability of a wider range of insurers to be involved in the coverage of large and/or complex risks.

8.4 Co-insurance also enables new entrants/smaller insurers to participate in an otherwise unavailable market and at an acceptable level of risk exposure and also to benefit from the experience and resources of larger insurers such as, for example, risk analysis and risk management skills.

8.5 The benefits to the insured of having a number of insurers co-insuring a particular risk are manifold and include, *inter alia*:

(a) having a number of well established and financially secure insurers underwriting the risk. This provides, in particular, a spread of credit risk to the insured, as well as greater stability. In the event of the insolvency of one insurer, the remainder of the risk is covered, or if one insurer decides to withdraw at renewal, it is likely that the remaining insurers will be able to increase their share of the risk; and

(b) having the expertise of insurers which may have specific skills in a particular segment can increase the ability of the co-insurance placement to cover and manage the particular risk adequately on behalf of the insured.

Annex A

1. **Financial aspects of the business insurance sector**

The Commission's profitability analysis

1.1 The Commission concludes from its analysis that: (a) "*profitability is high in business insurance*"; (b) "*profitability has been sustained over time in most Member States*"; and (c) "*High and sustained profitability in some Member States may be the result of the exercise of market power."* Moreover, the Commission concludes (on page 55) that *"business insurance is a profitable activity in the EU with a pre-tax average profit margin of 25 per cent".*

1.2 R&SA does not agree with Commission's assertions for the following reasons:

(a) the rate of return on business insurance varies considerably over the insurance cycle. As the Commission observes on page 22 – "*Cyclical patterns, typically running over a period of six to nine years (peak to peak) tend to be especially pronounced in insurance markets*". However, the Commission has only considered profitability for all lines of business insurance over a five-year period, which is an insufficient time period to cover the full insurance cycle for a range of different types of insurance (such as environmental liability, aviation, professional indemnity etc.). Moreover, the five years considered in the Commission's analysis coincides with the hardening of the insurance market post 11 September 2001. To have obtained a more accurate and representative picture of overall profitability, the Commission's analysis would have had to have been conducted over at least an 8-10 year period. This is supported by the fact that Figure VI.1 in the Commission's report shows that the insurance cycle for the different lines of insurance is significantly longer than the 5 year period considered as the analysis of the cycle does not cover peak to peak;

(b) the Commission's calculation of profitability in the EU is inaccurate due to the mismatch in the time period considered between the combined ratio, which is the average across all lines of insurance for 2005 only, and the average investment income, which is taken from the Swiss Re report covering the period 1994-2004. R&SA considers that the Commission should at the very least have considered the average combined ratio over the five year period for which it received the data. This is important because Figure VI.1 shows that losses were incurred by many insurers across many lines of insurance in the period 2000 to 2003;

(c) it is not clear whether the investment income figure derived from the Swiss Re report includes shareholders funds. R&SA considers that shareholders funds should be excluded from the profitability analysis as they represent the returns to investors who provide the mandatory capital which insurers must hold in reserve, and not returns on insurance premiums which are likely to reflect a lower level of investment return (premiums are likely to be invested in less volatile financial instruments such as bonds and not equities). Furthermore, the period considered by Swiss Re in relation to investment income includes periods of high interest rates, which increased the cost of capital;

(d) there are different dynamics affecting different lines of insurance. For example, in relation to SME property and motor insurance there is a large amount of data on which to base ratings and claims tend to be relatively stable and predictable. This means that it is easier to price this type of insurance more accurately. In comparison, any calculation of the ultimate cost of claims for environmental liability is subject to a range of uncertainties that is generally greater than those encountered for other classes of insurance business. As a result it is not possible to determine the future development of environmental liability claims with the same degree of reliability as with other types of claims. There are significant variations in the combined ratio for different lines of insurance from year to year, which means that averages across all lines of insurance gives rise to a misleading picture;

(e) profitability is just one of a number of measures used to assess the performance of insurance undertakings within a market, which in isolation says very little about the process of competition in the market. Moreover, there are many methodological problems with simply using profitability as an indicator of a lack of competition;

(i) there are a wide range of measurement issues as regards the treatment of various items in the profitability ratios which make it hard to measure profits with any degree of accuracy. The measure used by the Commission is largely based on accounting data which will be subject to variation in accounting practices between respondents and between countries;

(ii) as regards interpretation of survey questions, there is a real risk that different respondents responded to different interpretations of the profitability ratio (including different classifications, different product mixes etc.), which means that even comparing responses between insurance providers within a single Member State is problematic, let alone between insurance service providers in different Member States;

(iii) it is unclear precisely what the Commission has used as the benchmark against which to compare profit ratios in order to conclude that profit ratios are high in some Member States. For any profitability analysis to be persuasive, it needs to be shown to be robust to a range of measurement errors and differing assumptions;

(iv) the Commission's profitability ratio includes "expenses incurred" as the definition of cost, which is open to different interpretations by respondents. For example, it is unclear from such a definition whether to include only direct costs, whether to only include variable costs (i.e. excluding fixed overheads costs) etc.; and

(v) allocating costs for multi-activity firms (such as R&SA) is extremely difficult where publicly available company accounts are aggregated up to company level. Some costs may be directly attributable to the particular line of business but costs which are joint or common across multiple lines of business must be allocated using an appropriate methodology. Clearly, different respondents will have used different methodologies, which will undermine the validity of the overall comparison. (The problem in relation to the allocation of costs is acknowledged by the Commission on page 53);

(f) there are many reasons why profits may exceed the cost of capital in a competitive industry. For example firms may be expected to earn more than their cost of capital due to superior efficiency; profits may be high in markets where there is innovation; and profits may reflect successful risk taking. The Commission's analysis does not consider whether the profitability observed reflects any of these factors. For example, the finding that some of the new Member States have a higher cost base reflects the fact that business insurance in some new Member States (e.g. Lithuania and Latvia) was, until recently, operated as a state monopoly and was, therefore, less efficient. *[Business secrets].* In this connection, it is also important to note that, as former state owned enterprises operating in formerly centrally planned economies, the businesses concerned have been labour intensive in Latvia and Lithuania and, accordingly, the cost base had traditionally been quite high. In addition, these businesses are operating in different economic circumstances including member states with high levels of inflation and which do not bear direct comparison with those in other member states (see further below);

(g) large business risks are often complex and unique and require a tailor-made insurance programme. Accordingly, like-for-like comparisons between products provided by different insurance providers in different Member States are extremely difficult to conduct with any degree of accuracy; and

(h) measures of profitability do not necessarily equate to measures of market power. As mentioned above, more traditional measures of market power such as market shares, levels of concentration and barriers to entry all suggest that there is an absence of market power in the business insurance market.

1.3 In summary, R&SA is extremely concerned that the Commission is placing undue reliance on a single piece of profitability analysis which is unreliable, inconsistent, and suffers from a number of serious flaws. *[Business secrets]*.

Discrepancy of combined ratios

1.4 The Commission notes in its conclusions that "*some Member States tend to display consistently higher underwriting profitability in segments of small and medium-sized enterprises 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*". R&SA considers that this analysis fails to reflect the reality of the situation. It is also dependent upon the methodology used to apportion costs and revenues between SMEs and LCC's by insurers in each questionnaire response which, because the industry does not segment the market in this fashion, is likely to have lead to arbitrary results. R&SA would offer the following particular observations in this regard.

1.5 *[Business secrets]*.

1.6 There is no consistent pattern in the difference in the profitability achieved from SMEs and LCCs between Member States. The Commission's analysis shows that profitability for SMEs is lower than for LCCs in some Member States (such as Austria, Belgium and France), whilst it is higher in other Member States (such as Finland, Ireland and UK). Such significant differences in profitability between SMEs and LCCs between Member States is not explained by the Commission.

1.7 For cross-subsidisation to occur in practice, insurance providers must have market power in at least one market in order to use the high returns to offset the losses/lower prices in the alternative market. However, the Commission's analysis does not provide any evidence to show that insurers possess market power in relation to the supply of business insurance to SMEs.

1.8 There is a plethora of brokers, intermediaries and insurance companies selling insurance to SMEs, whilst barriers to entry are low as claims are generally of a lower value and more predictable in nature. Such market features indicate that the supply of insurance to SMEs is extremely competitive. Accordingly, any excessive returns would be quickly competed away.

1.9 The Commission's comparison of the profitability of business insurance to SMEs relative to the profitability of business insurance to LCCs does not compare like-with-like:

(a) the Commission's analysis aggregates SME and LCC profitability across all the different lines of insurance, which potentially suffers from the serious drawback that the insurers risk portfolio provided to SMEs differs to the risk portfolio of insurance provided to LCCs (due to differences in take-up of different lines of insurance); and

(b) international comparisons are misleading due to, for example, differences in the take-up of different lines of insurance between Member States and differences in the levels of inflation (this is particularly noticeable in new Member States such as Latvia and Lithuania where claims inflation has been driven by high levels of economic growth).

1.10 LCCs are generally sophisticated buyers who are aware of the alternative options they can use (including self insurance and other risk management techniques). They will only tend to place the risks with insurers they are not content to insure themselves or where they cannot find a cheaper alternative i.e. in the financial markets. For example, they tend to self insure the high frequency/low severity risks themselves through "captive" arrangements.

1.11 There is a much greater wealth of statistical data for insurers regarding the risks facing SMEs. Moreover, they tend to have a high frequency but low severity of loss, making it easier to price the risk more consistently and accurately compared to the complex tailor-made policies offered to LCCs.

Annex B

1. Competitive conditions in the European market for business insurance

1.1 R&SA would make the following observations on the general findings made by the Commission.

1.2 The Commission has suggested that the supply-side of the non-life business insurance market is fragmented and further that the European market is unconcentrated with close to 3,000 suppliers (page 34) and that "*new insurance firms can enter an insurance market quite quickly*" (page 22). This suggests that barriers to entry are relatively low and such structural factors would generally suggest that the supply-side of the market is competitive, which would appear contrary to the Commission's preliminary statements in connection with its profitability analysis.

1.3 In all Member States there are at least 10 non-life insurance suppliers, with the top 5 accounting for only 37 per cent of the market in Germany, 44 per cent in the Netherlands, 52 per cent in France and 53 per cent in the UK. This shows that the largest non-life insurance markets in the EU are all unconcentrated, which suggests that even the largest non-life insurance suppliers do not have market power. This further contradicts the conclusions drawn by the Commission from its profitability analysis. (In this regard, market shares and measures of market concentration are frequently used, *inter alia*, as a proxy for market power). Profitability analysis on the other hand is rarely used as a measure of market power due to numerous difficulties in measurement, benchmarking and interpretation of the results. This is considered in more detail below.

1.4 There is no analysis of the demand-side of the market; the preliminary findings are based purely on desk research and a survey of suppliers. In order for there to be an informed assessment of the demand-side, there would need to have been an analysis by the Commission of the extent to which customers are informed about different service providers, the extent to which there are costs involved in switching to alternative service providers, attitudes to risk, attitudes regarding insurance service providers based in other Member States and differences in the provision of information in different Member States. Any market assessment must understand the interaction between the demand and supply side of the market in order to draw any firm conclusions. It is also the case that national characteristics that are specific to each member state provide commercial limitations to the extent to which insurers can offer insurance services in other member states. These will include language differences, the need to understand differing legal systems and reputational issues which, typically, may discourage nationals from insuring key assets with a "foreign" insurance company which does not have an established track record in the member state concerned.

1.5 The Commission has not sought to assess the extent to which government/EU regulations inhibit competition by increasing barriers to entry/expansion and barriers to trade, nor has it sought to assess the impact of the recent changes in European regulations affecting the business insurance sector. For example, the Commission mentions (on page 36) that 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)*". In addition, the Commission acknowledges (on page 35) that the barriers posed by different regulatory systems have not been removed entirely, although it has not sought to analyse the extent to which such differences may affect competition. Any competition assessment would need to have considered (as a minimum based on evidence from some respondents) the impact of changes to the regulatory framework.

1.6 The Commission acknowledges that the questionnaires were complex and that the replies were not always as clear, accurate and exhaustive as expected. Furthermore, the Commission highlights the limitations of the data derived from the desk research (page

8), which include problems such as the difficulty in isolating the data to focus on business insurance, the fact that many insurers rarely distinguish between different client segments and the fact that insurers rarely adopt the same insurance classifications. Such data inconsistencies raise serious doubts regarding the reliability of the Commission's analysis. The Commission correctly acknowledges (on page 8) that "*it can be difficult to make valid international comparisons when classification systems differ between Member States*".

1.7 There is a general lack of analysis of the dynamics of the market such as the extent to which there has been entry, expansion or exit in the different insurance markets. Clearly, in markets where entry and expansion is relatively easy, it would be extremely difficult for the incumbent suppliers to exploit any "market power" (either individually or tacitly) which might exist.

<u>Annex C</u>

Responses to issues for consultation

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?

For the reasons set out in this Submission, it would be inappropriate to draw any firm conclusions on the basis of the conclusions drawn by the Commission. In addition, R&SA considers that it would not be appropriate for the Commission to base any future policy decisions on this data. Further, the Commission should expect to find differences between emerging and developed/mature Member State insurance markets. In addition, the Commission required questionnaire recipients to provide data based on the Commissions definitions of SME's and LCC's – definitions which required R&SA to make certain assumptions and definitions which do not reflect the way in which insurers would categorise their business operations; it seems very likely that most and perhaps all questionnaire respondents would have different ways of categorising their business operations. In addition, the penetration of insurance may be lower in some emerging markets and this may serve to distort the figures upon which the Commission seeks to rely.

2. **"Best terms and conditions" clauses**

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?

In R&SA's experience, "best terms" clauses are frequently used by re-insurers. However, in R&SA's experience "best terms and conditions" clauses are used by co-insurers very infrequently and in circumstances where the risk is particularly complex or new, and there is a lack of capacity in the market.

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

"Best terms and conditions" would usually appear at the time an underwriter is asked to provide terms on a "subscription" or co-insurance slip, next to the percentage they are willing to take of the risk.

How is the clause enforced?

There is no "enforcement" of a best terms clause. The clause is added at the quotation stage by an underwriter. If the risk is accepted by the client/broker then the policy is drawn up on the basis of the terms in the slip.

What is the effect of this type of clause on the market?

R&SA understands that best terms and conditions clauses may sometimes be used to ensure that the broker is in a position to place the whole of the risk on behalf of its client - the alternative being that parts of the risk are not covered as there may not be enough capacity at the terms quoted by the lead insurer. The customer might otherwise not have insurance cover for the percentage that cannot be placed.

3. **Long-term agreements**

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.

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.

As noted in this Submission, R&SA's experience is that the majority of insurance contracts proceed by way of one year terms. Where multi-year contracts are used, R&SA considers that such contracts usually come into existence at the request of the client, brokers or other intermediaries.

4. **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?

This question appears to be addressed to, and only fully answerable by, brokers and other intermediaries.

As noted in this Submission, R&SA believes that the obligation to manage conflicts of interest arises out of the fiduciary duties owed to the client by the broker or other intermediary. It is the responsibility of the broker or intermediary to manage these potential conflicts of which the transparency of commission payments may be only one.

R&SA would, in principle, support measures to introduce transparency in the distribution channel but considers that brokers and intermediaries (rather than insurers) are responsible for managing potential conflicts of interest (including the transparency of commission payments) under the supervision of the appropriate financial services regulator.

However, R&SA considers that a move towards transparency could result in unintended consequences such that certain brokers and other intermediaries might conclude that it is no longer cost-effective for them to provide current levels of advice to the SME sector going forward. In this connection, in the UK the demands of the SME sector can vary widely and while some risks will be relatively straightforward, others will be more complex and will require the dedication of greater resources by brokers and other intermediaries. R&SA believes that these potential unintended consequences should be carefully evaluated before any changes are introduced.

R&SA notes that its terms with intermediaries in the UK presently require the intermediary to disclose its terms of remuneration to the client if requested. This is consistent with the requirement set out in section 4.6 of the ICOB rules for an insurance intermediary promptly to disclose commission payments on request from a commercial customer.

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?

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?

Again, this question appears to be addressed to, and only fully answerable by, brokers and other intermediaries. R&SA understands that brokers and other intermediaries rebate commissions to their clients in both the SME and LCC segments and R&SA does not (and has no intention of) prohibiting brokers and other intermediaries from rebating commissions to their clients.

5. **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?

As noted in this Submission, the Commission should expect to find differences between emerging and developed/mature Member State insurance markets both in terms of the understanding of certain risks and the levels of sophistication of insurers generally.

Which sorts of benefits have you experienced, as a business insurance customer, from the forms of cooperation among insurers described in the present Report?

This question is directed at business insurance customers.

As a business insurance customer, have you ever experienced that the forms of cooperation among insurers described in the present Report were hindering competition?

This question is directed at business insurance customers.

Royal & SunAlliance

30 March 2007