

EXECUTIVE SUMMARY AND CONSULTATION¹

I. EXECUTIVE SUMMARY

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

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

The Sector Inquiry has examined the following areas:

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

1. FINANCIAL ASPECTS OF THE BUSINESS INSURANCE SECTOR

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

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

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

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

Finally, it is worth noting that some Member States tend to display consistently higher underwriting profitability in segments of small and medium-sized enterprises (SMEs) than in

¹ The full text of the interim report on the business insurance sector inquiry is available at http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/interim_report_24012007.pdf

segments of large corporate clients (LCCs). This might indicate that in these Member States, underwriting for SMEs is used to cross-subsidise low returns in the LCCs' segment.

2. DURATION OF CONTRACTS IN THE BUSINESS INSURANCE SECTOR

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

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

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

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

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

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

3. REINSURANCE

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

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

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

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

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

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

4. STRUCTURE, FUNCTION AND REMUNERATION OF DISTRIBUTION CHANNELS

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

The *structure* of distribution channels varies from one Member State to another due to historical and cultural reasons, but differences also exist according to the insurance lines and/or client profiles concerned. Although many insurance companies operate through more than one distribution channel, the business insurance market in the EU is predominantly served by brokers. Exclusive agents constitute the second most used channel of distribution across the EU in most insurance lines.

Certain distribution structures (e.g. networks of exclusive agents) can, under specific circumstances, act as entry barriers. Conversely, the existence of a broker channel can facilitate market entry for foreign insurers that do not have their own or a sufficiently developed distribution network. According to the survey of insurers, access to distribution infrastructure is among the most important factors influencing insurers' decision to enter a new market.

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

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

Brokers act both as an advisor to their clients and as a distribution channel for the insurer, often with underwriting powers and binding authorities. This dual role could be a source of conflict of interest between the objectivity of the advice they provide to their clients and their own commercial considerations.

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

clients, this number tends to increase in accordance with the complexity of the risk to be insured. The larger the risks, the better advised are the clients.

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

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

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

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

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

5. HORIZONTAL COOPERATION AMONG INSURERS

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

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

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

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

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

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

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

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

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

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

Cooperation on *technical specifications, rules or codes of practice concerning safety equipments* does not seem to have a substantial impact on insurers' policies in a large number of Member States (Cyprus, Denmark, Estonia, Ireland, Italy, Lithuania, Luxembourg, Latvia, Malta, Poland, Portugal, Slovenia and Slovakia). Conversely, it seems to play a role in particular in Austria, Belgium, Germany, Finland, France, the Netherlands, Sweden and in the UK. Such

cooperation concerns mainly the Property/Business Interruption, the Transportation and the Motor insurance lines. It appears to be marginal in the Aviation and in all the Liability insurance lines.

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

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

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

6. CONCLUSIONS AND NEXT STEPS

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

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

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

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

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

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

II. CONSULTATION

1. ISSUES FOR CONSULTATION

The Commission is keen to engage in dialogue with market participants and authorities about the preliminary findings of the Sector Inquiry presented in the Interim Report. Therefore, the Commission invites industry participants, business insurance customers and other interested parties to submit their views and comments on such preliminary findings. In addition, stakeholders are welcome to contact the Commission directly in order to discuss any competition related issue in business insurance.

The Commission has highlighted a set of issues for consultation. This will enable stakeholders to put forward their views on the key questions. However, **any other comment of all stakeholders on the preliminary findings presented in the Interim Report, not directly related to the issues identified below, is also very welcome.**

The issues for consultation that the Commission has highlighted are the following:

Discrepancy of combined ratios

Q.1 Are there compelling justifications for the apparent discrepancy in the level of combined ratios of SMEs and LCCs observed in some parts of the EU-25?

"Best terms and conditions" clause

Q.2 How widespread is the use of the so-called "best terms and conditions" clause in the reinsurance and in the co-insurance markets? Where does this type of clause originate?

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

Q.4 How is the clause enforced?

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

Long-term agreements

Q.6 Have you experienced that the duration of insurance contracts represented a barrier to entry for insurers wishing to penetrate new markets and/or acquire new customers? Please explain your answer also taking into account the existence of termination and of automatic renewal/extension clauses.

Q.7 Have you experienced that the duration of insurance contracts was a serious obstacle for switching to a different insurer? Please explain your answer also taking into account the existence of termination and of automatic renewal/extension clauses.

Intermediaries' remuneration

Q.8 To what extent do independent insurance intermediaries (brokers and multiple agents) disclose remuneration paid by insurers (i.e. commissions, contingent commissions including profit commissions, fees for services provided and other payments) to their insurance broking clients?

Commission rebating

Q.9 In your Member State, do independent insurance intermediaries rebate commissions to their clients? How common is this practice for SME clients? How common is it for LCCs?

Q.10 Are there any agreements between insurers and independent intermediaries not to rebate commissions to insurance broking clients? Are there any other practices that would discourage independent insurance intermediaries from rebating commissions to insurance broking clients?

Horizontal cooperation

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

Q.12 Which sorts of benefits have you experienced, as a business insurance customer, from the forms of cooperation among insurers described in the present Report?

Q.13 As a business insurance customer, have you ever experienced that the forms of cooperation among insurers described in the present Report were hindering competition?

2. PROCEDURE FOR CONSULTATION

The consultation will be open for 12 weeks and will close on **10 April 2007**.

Replies should be sent to the email address:

Comp-Ins-Inquiry-Feedback@ec.europa.eu.

Respondents are strongly encouraged to provide a reply of not more than 20 pages to allow for efficient treatment of the feedback by the Commission. There shall be only one submission of comments per undertaking.

Respondents are advised that their contributions may be published on the Commission's website.

In view of the sensitive nature of such evidence, market participants may wish to provide submissions to the Commission on an informal and confidential basis. The Commission will assume responsibility for preserving the confidentiality of any material provided.

Please indicate in your reply whether you **do not** authorise the Commission to publish your contribution. In case your comments contain confidential information, please provide a non confidential version.