The European Commission's Final Report on the Business Insurance Sector Inquiry

by Philip Orange

Overview

On 25 September 2007 the European Commission issued the final report of the competition sector inquiry on business insurance. The inquiry was initiated in June 2005 under Article 17 of Regulation (EC) No 1/2003. The final report followed wide public consultation and some additional fact finding, following publication of the Commission's interim report in January 2007.

The final report raised concerns about the operation of the market with respect to the following aspects of business insurance:

- Certain long-standing and widespread industry practices in the reinsurance and co-insurance markets involving the alignment of premiums, which the Commission thought may lead to higher prices for large commercial insurance. The report left open the question whether these practices constitute infringements of the prohibition on restrictive business practices in Article 81(1) of the EC Treaty, but invited the insurance industry either to justify the business practices under the competition rules, or reform them.
- The lack of transparency of remuneration and the presence of potential conflicts of interest in insurance brokerage, which the Commission thought may inflate prices and reduce choice, particularly for small and medium-sized enterprises (SMEs). These issues will be explored further during the Commission's review of the Insurance Mediation Directive.
- The Block Exemption Regulation for insurance (358/2003) lapses in 2010, and the Commission has yet to be persuaded that the Regulation (which treats the insurance industry differently from other industry sectors) is still necessary.
- Instances where a pervasive market practice of entering into long-term contracts may lead to cumulative foreclosure (i.e. the exclusion of new market entrants from a particular market).

Background

In June 2005 the EC initiated a sector inquiry under the EC competition rules into the provision of insurance products and services to businesses in the European Community. Sector inquiries under the EC competition rules are new and

potentially highly significant. Previous sector inquiries into the retail banking and energy sectors are resulting in some significant changes to market practice.

The business insurance sector inquiry resulted from concerns that in certain areas of both writing and distribution of business insurance, competition may be restricted or distorted within the Community. The purpose of the inquiry was to reach a better understanding of the functioning of the sector in order to identify any concrete restrictive practices or distortions of competition within the scope of Articles 81 or 82 of the EC Treaty. The inquiry was limited in geographical scope to the EU-25 member states (i.e. the 27 member states excluding Bulgaria and Romania) and was subdivided between the 10 member states who joined on 1 May 2004 and the other 15 member states.

Phase one

The inquiry took place in two distinct phases. Phase One consisted of desk-based research and analysis of responses to a questionnaire-based survey of major market participants. These included EU insurance companies, insurance intermediaries, reinsurance companies and various trade associations of insurers, intermediaries and risk managers.

An initial survey was conducted among 27 national insurance associations, 38 intermediaries' associations and 12 risk management associations. The associations were requested to provide information on the structure of national markets, the companies active in them and on distribution channels and certain specific market-related issues.

A second survey of 28 national insurance associations was carried out in 2006, focusing on horizontal cooperation at the associations' level in the framework of the Block Exemption Regulation (Regulation 358/2003), which block-exempts certain agreements in the insurance sectors from the prohibition on restrictive business practices in Article 81(1). These include joint establishment, distribution of standard policy conditions and joint coverage of risks.

The main data was provided by a survey of insurance companies in all member states and of intermediaries in a selection of member states. The sample consisted of 250 insurance firms, representing both major and smaller firms, and 164 intermediaries selected at random, but limited to 14 member states and limited to insurance brokers and similar intermediaries. It excluded tied agents and bank channels. A survey of eleven reinsurers was also carried out, based on a short questionnaire, concerning the existence and prevalence in the market of the so-called

'best terms and conditions' clauses, contingent commissions paid to reinsurance brokers and the activity of reinsurers relative to the Block Exemption Regulation.

Phase two

The interim report was published on 24 January 2007 and comments were invited on its findings. The interim report highlighted:

- the discrepancies between the combined ratios achieved for business with SMEs and large corporate customers (LCCs) respectively;
- "best terms and conditions" clauses;
- intermediaries' remuneration and commission rebates;
- horizontal cooperation between insurers; and
- long-term agreements.

A public hearing was held in Brussels in February 2007, attended by over 240 representatives from the industry. There was also a targeted series of questionnaires on 'best terms and conditions' clauses and broker commission rebates. The questionnaires were sent to insurance supervisors, associations and competition authorities. There was also a questionnaire on profitability, but the findings were not included in the final report.

Main findings of the final report

Financial aspects of the industry

The report found that profitability in the insurance business sector has been sustained over recent years, with some variations. However, it also found that underwriting profitability varied significantly in terms of business lines and member states. Profit ratios varied by a factor of 1 to 3 across the EU-25 for the same insurance lines. The Commission found these discrepancies "striking". The report also found that there was a wide variation in insurers' incomes for specific product lines within the same member state. Profitability also varied significantly across the EU-25, according to whether the business was with SMEs or LCCs, suggesting that broker power had a significant influence in the sector.

Harmonisation of terms and condition in co-insurance and reinsurance

The Commission acknowledged that co-insurance and reinsurance are important mechanisms underpinning the EU insurance industry and insurability of large risks, leading to greater capacity and risk diversification, which itself leads to lower prices and better terms. However, the report found evidence to suggest that some market

practices might fall within the scope of Article 81 of the EC Treaty and might be potentially anti-competitive. This was particularly the case with "best terms and conditions" clauses – guarantees that a reinsurer will obtain terms no less favourable than those offered to any other reinsurer. These clauses are also present in the co-insurance market, especially in relation to premiums.

The interim report considered that best terms and conditions clauses were likely to be to the detriment of customers, and might amount to a restriction of competition. There was widespread market practice, not necessarily in the actual use of best terms and conditions clauses but a market practice alignment of premiums and other conditions. The provisional view taken in the final report is that the practice may fall within Article 81(1) of the EC Treaty. Further, the Commission was not persuaded that the practice was indispensable (as would be required in order for the practice to be justifiable under Article 81(3)). The Commission thought that the practice of revealing the price of the lead insurer in the subscription process, guaranteeing the lead insurer's share and aligning the terms of cover (other than the premium) was less likely to raise competition objections. Despite the fact that the use of best terms and conditions clauses appears to have been normal market practice for some considerable time, the report concluded that the insurance industry should engage in a critical reappraisal of the practice.

The Commission's observations related only to elements of certain business practices in the two-stage subscription procedure. The Commission believes that these elements are not essential to the operation of that procedure and invites customers to be aware of alternatives and ensure that these options are fully explored by risk managers and brokers.

The Commission did not raise any concerns in the final report about other ways of awarding co-insurance and reinsurance business (such as vertical marketing, ad hoc syndication between insurers and standing arrangements such as pools). Whether the use of these procedures might give rise to competition concerns would require case-by-case analysis.

Distribution of business insurance

The Commission recognised that the fact that brokers act as advisers to clients and as distribution channels for insurers is a potential source of conflicts of interest. Conflict can also arise from remuneration arrangements, including the use of contingent commissions. The Commission felt that current market practices,

particularly the lack of spontaneous disclosure of remuneration from insurers can lead to clients not being able to make fully-informed choices.

Contingent commissions were also thought to have the potential to undermine fair competition in the insurance market in terms of cover, service and financial strength. They had the potential effect that insurers might be compelled to compete on levels of remuneration in order to buy distribution or influence brokers' choice. The Commission thought that disclosure of commission and the services provided by insurers might help mitigate conflicts of interest. In this connection the position in the business insurance sector should be compared with the position in the securities and banking sectors (where disclosure is required). However, disclosure alone is probably not sufficient to mitigate potential conflicts of interests.

The interim report explained that the prohibition by insurers of commission rebating could amount to resale price maintenance and would therefore not benefit from the block exemption granted by the regulation on vertical agreements and concerted practices. Horizontal agreements or concerted practices of intermediaries (or decisions of their industry associations) not to rebate commissions to clients are likely to constitute restrictions of competition.

In the final report there was no evidence from market surveys conducted in three member states as to the existence of private agreements or practices acting to prevent or discourage independent intermediaries from rebating commission. However, the response from Italian brokers indicated certain confusion as to the Italian broker association's policy in this area. The Commission felt that more clarification was required. In Germany, for example, the practice is prohibited.

The Commission thought that competition market dynamics in relation to the price of mediation services appears limited as far as SMEs are concerned. SMEs' apparent lack of concern with the issues can lead to a misconception as to the amount of commission actually being paid. The Commission thought that this issue has multiple dimensions, which require careful consideration. The Commission will look at the issue in the context of the planned review of the Insurance Mediation Directive. It will also take into account the treatment given to similar situations in other sectors, in particular the regime for investment services under the Markets in Financial Instruments Directive (MiFID), in order to ensure regulatory neutrality.

Horizontal cooperation amongst insurers

Some forms of cooperation between insurers are currently exempted by Regulation 358/2003 – the Block Exemption Regulation (BER). The BER expires on 31 March

2010. The report found that use of the BER varies considerably between member states.

Many respondents to the inquiry maintained that the forms of cooperation and agreement exempted by the BER are pro-competitive, and the majority were in favour of prolonging the BER when it expires. The Commission acknowledges the attachment (especially on the part of insurers) to the BER. However, according to the Commission, the respondents failed to make a distinction between the desirability of the forms of cooperation covered by the BER and the desirability of the BER itself. The Commission noted that there are historic reasons for the BER; it excludes certain generic types of agreement from Article 81(1) of the Treaty, obviating the need for individual exemptions. However, undertakings are no longer required to notify forms of cooperation to the Commission. Instead, they had to assess compatibility of their behaviour with the competition rules, with help if necessary from their external counsel and other advisers.

According to the Commission, it is arguable that for business insurance, a form-based sectoral block exemption is no longer needed; self-assessment is sufficient, as in other business sectors. Even without the insurance BER, the insurance industry would continue to benefit from the terms of the horizontal and vertical Block Exemption regulations.

There will be an ongoing discussion on this issue; the terms of the enabling legislation require the Commission to submit a report on the functioning and future of the BER by 31 March 2009. In view of this, the Commission wished to encourage industry participants and other stakeholders to continue their reflection in the interim, focusing on the role of the BER in the legal order rather than the specific forms of cooperation it covers.

Duration of business insurance contracts

The Commission felt that the general practice of entering into excessively long-term contracts might raise competition concerns in terms of foreclosing the market to new entrants. Concerns about this were also raised by some market participants, particularly in relation to Austria and Italy.

While the Commission was able to intervene under the competition rules in certain circumstances, it pointed out that this was not always the preferred route. However, the Commission thought it was appropriate to consider the situation in Austria further. In Italy, recent regulatory intervention appears to have changed the

environment, so that long-term contracts no longer appear to be susceptible of foreclosing the market to new entrants.

Next Steps

With the publication of the final report, the Commission invites the parties concerned by the various issues identified in the report to carry out their own assessment, and engage in a dialogue with the Commission, with a view either to clarifying the situation, modifying market behaviour or, if necessary, proposing enforcement proceedings. The commission states that this process will be carried out in accordance with normal competition advocacy and enforcement procedures would apply.

Conclusions

Although the final report makes it clear that the Commission has some competition concerns about certain aspects of the insurance business sector, the Commission appears to be rather less critical of the insurance business sector than it has been of other sectors in its previous sector inquiries. It does not appear that the Commission is contemplating European-wide enforcement action in the various areas identified, although it is possible that enforcement proceedings in individual member states or groups of member states may follow, particularly in the case of the market practices identified in co-insurance and reinsurance and the use of long-term contracts.

As far as the distribution of business insurance is concerned, those competition concerns identified by the final report will be addressed as part of the planned review by the Commission of the Insurance Mediation Directive.

However, it does seem likely that the insurance Block Exemption Regulation will not be renewed when it lapses in 2010, unless the European insurance industry is able to engage the Commission in active dialogue and persuade it that the forms of cooperation and agreement exempted by the Regulation are, as some respondents to the inquiry maintained, pro-competitive rather than anti-competitive.

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