

EU INSURANCE BRIEFING



7 February 2007

EU competition inquiry reveals complexity of insurance sector

On 24 January, the European Commission published an interim report on its inquiry into competition in business insurance. At 164 pages, the report is worthy of the sector's importance (the Commission cites gross premiums in 2004 of €345 billion, representing 3% of the EU's GDP). This briefing comments on some of the principal findings of the report.

Firstly, the report must be seen in context: it is in an interim report only and the first step in the Commission's consultation exercise, consisting of a public hearing on 9 February, review of submissions and adoption of a final report in autumn 2007. Secondly, the report recognises the size and complexity of the EU insurance sector: much of the report describes the nature and function of business insurance, the market and its integration within the EU. The balance of the report sets out the Commission's initial findings regarding five topics: (i) variations in profitability in geographical and product markets; (ii) duration of contracts; (iii) reinsurance terms and conditions; (iv) distribution post-Spitzer; and (v) cooperation among insurers.

General

A close reading of the sections covering these five areas suggests that the Commission has no pre-conceptions about how it might tackle any behavioural or structural obstacles to competition in the

market. The report adopts a less aggressive and prescriptive tone than the results of the parallel inquiries into the energy and banking sectors (DG Competition of the Commission has long experience in investigating and fining anti-competitive behaviour in these sectors, for example, the €124 million fine recently confirmed by the European Court against the Austrian "Lombard Club" banking cartel).

This tentative approach no doubt stems from the diversity and complexity of the sector and the absence (unlike in the banking sector) of significant pressure to react to public dissatisfaction.

Variations in profitability

With regard to variations in profitability, the report provides a descriptive comparison, using the combined ratio. The Commission concludes that the sector is generally profitable, but with significant disparities, in particular between the original 15 Member States and the 10 new States which acceded in 2004, between product lines and between small and medium-sized enterprises (SMEs) and large corporate clients (LCCs). These disparities could suggest, for example, market fragmentation and exercise of market power. The Commission will further investigate "...a possible causality between financial performance and possible barriers to competition...".

Insurers should reflect on this "possible causality". Given the acknowledged and well-documented shortcomings in the creation of a Single Market in insurance, these disparities might well be historical, cultural, regulatory and legal and,

consequently, have no relation to any breach of EC competition rules: an insurer which benefits from demand-side inertia is not breaching competition rules. Similarly, any measure of current profitability needs to be put in context: in some cases, it may represent stricter underwriting and higher premiums following losses in earlier years arising out of poor risk assessment and claims management; in addition, with Solvency II looming and its emphasis on risk-based management, insurers could be forgiven for improving their risk management techniques and, consequently, enjoying the fruits of their efforts.

Long-term insurance

In the second topic identified, long-term insurance, the Commission notes that long-term insurance contracts tend to be limited to certain jurisdictions e.g. Italy; they are not inherently unlawful and may, despite the risk of foreclosure of markets, be justifiable on consumer benefit or other grounds. The Commission concludes that its analysis indicates “...issues that should be taken into account when assessing the competition concerns” raised by such agreements.

Although this is not a clarion call for change, parties to such agreements should be ready to defend them on the ground that there is no restriction of competition, for example for the simple reason that the contract, although long-term, can be easily terminated, or that a restriction is justifiable in the light of the relevant competition rules.

Reinsurance

The third concern, reinsurance, focuses on two issues, supply substitutability (i.e. the ability, dependent on ratings, of a cedant to substitute one reinsurer for another) and “best terms and conditions”. In the latter case, the Commission concludes that, by excluding price differences based on

solvency and other differences between reinsurers and, potentially, fixing prices, such clauses can operate to the detriment of the direct insurers and, ultimately, the final customer.

Reinsurers may have to advance arguments to justify the practice (if, in fact, it is widespread) and the allegedly higher prices it generates. Similar concerns and justifications may arise in co-insurance.

Distribution

Rather more sensitive is the analysis of distribution of insurance, where the “Spitzer effect” has clearly changed market behaviour in the EU. DG Comp has carried out a traditional competition law analysis of distribution agreements between insurers and intermediaries, including the now notorious contingency commission agreements. Whilst the report makes it clear that barriers can exist (e.g. exclusivity), that retail price maintenance (e.g. through no rebating or, worse, bid-rigging) is challengeable and that contingency commissions will be scrutinised further, the Commission has not (yet) recommended specific prohibitions or changes in the current rules.

By way of example, non-disclosure of an intermediary’s remuneration (especially where the commission is “bundled” with the cover) not only “...reduces the potential for price competition in relation to mediation services...”, it also creates a conflict of interest, which can be (and has been) more easily remedied by self regulation and a more robust attitude by, in particular, SMEs.

Having just digested the Insurance Mediation Directive, the sector needs to resist any enthusiasm to legislate regarding commissions, contingency or otherwise, by encouraging voluntary disclosure of all remuneration.

Cooperation among insurers

The last concern is cooperation among insurers, for example, pooling arrangements, exchanges of data and standard policy conditions. The Commission's conclusion is rather a *mea culpa*: having noted extensive differences among Member States and insurance classes, the Commission casts doubt on the effectiveness of the exemption provided by the 2003 block exemption Regulation and questions whether existing cooperation between insurers is justifiable at all. This is potentially serious, given that the 2003 Regulation, which expires in 2010, replaced a previous text dating back to 1992 and provoked extensive debate at the time. It could mean loss of access to data, expertise and networks essential to proper pricing, appropriate wordings and sharing of insurance risks.

The sector will therefore need to reflect on how to promote open and transparent cooperation (for example, non-binding clauses and access to data for all interested parties) and whether it would accept the general self-assessment regime. Certainly, exchange of data (for example) is a vital issue for the sector and is also of continuing interest to the regulators and courts. (See, for example: (i) in the insurance sector, the continuing saga of unlawful behaviour in the Italian motor insurance market and the European Court's judgment in Joined Cases C-295/04 to C-298/04, *Manfredi and Others v. Lloyd Adriatico and Others*; and (ii) for data exchange in the banking sector benefiting from exemption from the competition rules, the Court's judgment in Case C-238/05, *Asnef-Equifax*.)

Industry input

The report concludes by announcing further investigations and by inviting interested parties to respond to thirteen questions focusing on the five topics above. These questions illustrate the Commission's need for basic market feedback and so represent an excellent opportunity for the sector to explain its structure and practices, to promote change

where needed and to maintain its prominent international position. A sector inquiry can only provide background information to a separate individual investigation. Thus, the report cannot be used against an economic operator in individual proceedings.

In sum, the report echoes the Commission's cautious approach in the past to competition in the insurance sector: over the last fifteen years, the Commission has periodically negotiated changes in the market, e.g. the 1992 block exemption Regulation, the 1998 renewal of the P&I clubs' exemption, the 2003 block exemption and, most recently, adjustments in the aviation insurance sector. These regulatory interventions illustrate the powers and general approach of the Commission. Certainly, at this stage, DG Comp is far from any definitive conclusions: by way of example, action by DG Comp on contingent commissions could follow under the competition rules (if bid-rigging is suspected), but it could equally easily take the form of a self-regulatory initiative – encouraged by the Commission's DG Internal Market – designed to resolve the risk of conflict of interest (and which is not a competition concern); self-regulation might well be preferred to, for example, a legislative amendment of the Insurance Mediation Directive.

Because the report is only interim, the Commission still has an "open mind" on many of the report's findings. The Commission welcomes additional information from the sector or, as one DG Comp official has put it, "constructive criticism"; individual companies can therefore provide input, either to challenge existing behaviour and structures (i.e. competition rules as a "sword") or to justify them (i.e. competition rules as a "shield") or to encourage DG Comp to re-think an issue, in particular in conjunction with their colleagues in DG Internal Market.

The history, size and diversity of the market preclude a “one size fits all” competition solution to perceived obstacles. As the Commission regularly notes in its merger decisions, “insurance can be divided into as many product markets as there are different kinds of risks covered”.

The sector should state its case, starting with the 13 questions set out in the report.

The deadline for replies is 10 April 2007.

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