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**BRIEFING**

14 June 2005

Re: **European competition watchdog to dissect commercial insurance... what is all the fuss about?**

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1. **Introduction**

The European Commission announced yesterday, 13 June 2005, its decision to launch a comprehensive inquiry in the financial services sector and in particular retail banking and business insurance. As reported in our previous briefing on the subject<sup>1</sup>, the financial services sector has been identified by the Commission as one of the most relevant areas in achieving economic growth and paramount to the efficient operation of many other markets. The competition inquiry will be complementary to the Commission's parallel initiatives to remove regulatory barriers to a Single Market in financial services.

The purpose of the inquiry will be to identify any barriers to competition whether resulting from regulation, State subsidy or private initiative. It will last for a maximum of 18 months with the interim results coming out in 6 months. Once such barriers are identified, the Commission will "go on to propose solutions, working closely with national administrations, regulatory bodies and competition authorities<sup>2</sup>."

According to the Commission, business insurance is especially targeted because, notwithstanding the size of the relevant risks and the extensive information available to clients, cross-border competition is limited. The inquiry will concentrate on the provision of insurance services and products to businesses, and insurance intermediation, including relevant reinsurance aspects, e.g. property and casualty insurance and reinsurance. However, the Commission is still refining the scope of the inquiry.

Given the importance of the inquiry for the commercial insurance industry, this briefing considers:

- the relevant competition rules and how they affect the insurance industry;

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<sup>1</sup> See: <http://www.step toe.com/publications/PI9587.pdf>.

<sup>2</sup> See "The Competition Principle as a Guideline for Legislation and State Action - the Responsibility of Politicians and the Role of Competition Authorities", Neelie Kroes, 12<sup>th</sup> International Conference on Competition, Bonn, 6 June 2004.

- the nature of sectoral inquiries and their form, including the Commission's powers;
- the likely consequences for individual insurers of falling to respond to the Commission's questionnaires or a Commission finding of the existence of anti-competitive practices; and
- finally (and by way of example), the most recent insurance related case to be examined by the Commission.

## 2. What competition rules?

In the European Union ("EU"), anti-competitive behaviour is regulated by Articles 81 and 82 of the EC Treaty. Article 81 applies to anti-competitive agreements, decisions or concerted practices. Article 82 prohibits the abuse of a dominant position.

However, not all agreements that fall within Article 81 are prohibited. Article 81(3) exempts practices that:

- contribute to improving the production or distribution of goods or to promoting technical or economic progress,

while

- allowing consumers a fair share of the resulting benefit,

and which do not

- impose restrictions which are not indispensable, and
- eliminate competition in a substantial part of the products in question.

The European Commission has in the past adopted a number of individual exemption decisions in the insurance sector, including co-operative agreements, insurance and re-insurance pools and marine and aviation insurance. Furthermore, the Commission has adopted a block exemption Regulation<sup>3</sup> which is specific to the insurance sector and which sets out certain types of co-operation agreements between insurance companies which, under certain conditions, are specifically exempted, including agreements for:

- the establishment of non-binding standard policy conditions;
- the exchange of statistical information for the calculation of risks; and
- the creation of insurance pools.

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<sup>3</sup> Commission Regulation (EC) No 358/2003 of 27 February 2003 on the application of Article 81(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector.

The above may only be exempted provided that the co-operation does not go beyond what is justified by consumer interest and does not concern the coverage, terms or premiums charged in insurance policies offered to consumers.

Conversely, under Article 82, the abuse of a dominant position is absolutely prohibited and no exemption is available.

Based on the above, when announcing the new probe into the area of commercial insurance, the Commission expressed its concerns that possible distortions of competition result from the way the industry is organised and, in particular, the following business practices:

- the joint setting of standard policy conditions by insurance associations and committees (offering customers only very limited leeway to negotiate the terms of coverage);
- co-operation in the context of insurers' associations and co-insurance arrangements; and
- agreements between insurers or reinsurers and intermediaries (which may limit the incentive to compete);
- the scope of pool agreements; and
- lack of access to risk data and statistics, and to distribution channels (especially in relation to cross-border entry)<sup>4</sup>.

### 3. **Sectoral Inquiries**

The Commission's power to launch sectoral inquiries derives from Regulation 1/2003<sup>5</sup>, according to which:

"Where the trend of trade between Member States, the rigidity of prices or other circumstances suggest that competition may be restricted or distorted within the common market, the Commission may conduct its inquiry into a particular sector of the economy... In the course of that inquiry, the Commission may request the undertakings or associations of undertakings concerned to supply the information necessary for giving effect to Articles 81 and 82 of the Treaty and may carry out any inspections necessary for that purpose."

In particular, the Commission has the power to:

- request companies and associations to provide all necessary information;

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<sup>4</sup> See "Communication by Commissioner Kroes in Agreement with Commissioner McCreevy".

<sup>5</sup> Article 17.1, Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty.

- interview any natural or legal person who consents to be interviewed; and
- inspect companies and associations.

In the first phase of the inquiry, the Directorate General for Competition of the Commission will issue questionnaires to stakeholders, including consumer associations, in order to gather the necessary information to form a view of the state of the market. The insurance inquiry will initially cover all 25 Member States.

Companies receiving a questionnaire must respond by the deadline set by the Commission, failing which they risk the adoption by the Commission of a Decision, which can result ultimately in the imposition of fines.

The knowledge gained will help the Commission to form a view as to whether there is a need for enforcement initiatives in specific Member States or markets, including inspections of the premises of individual companies.

#### 4. **Inspections**

The Commission's inspections of companies and associations, also known as "dawn raids," include its right to:

- enter the premises, land and means of transport of an entity (including the homes of directors, managers and other members of staff);
- examine books and other records related to the business (and take copies or extracts in any form);
- seal any business premises and books or records; and
- ask any representative or member of staff of the entity for explanations of facts or documents relating to the subject matter and purpose of the inspection.

An example of such inspections in the financial services sector is the Commission's simultaneous inspections of the premises of Euronext and certain other financial services companies in Paris, Amsterdam and London on 23 July 2004. The European Commission was investigating the possible existence of business practises allegedly breaching European competition rules. The Commission officials taking part in the operation were assisted by the relevant local competition authorities.

Following the investigation, the Commission clarified what should be seen to apply to all such inspections: that they normally take place at the preliminary stage of a probe for information and that "the investigation measures taken do not prejudice any final outcome".

## 5. Consequences

In the first phase of the inquiry, the Commission has the power to impose a fine of up to 1% of a company's annual turnover if it, intentionally or negligently, supplies incorrect or misleading information in response to a questionnaire sent by the Commission.

If a company fails to respond to a questionnaire altogether, the Commission has power to require, by Decision, the company to supply the information. Failure to provide a reply within the time limit set in the Decision, or the provision of incorrect, incomplete or misleading information, may result in:

- a fine of up to 1% of the company's annual turnover<sup>6</sup>; and/or
- a periodic penalty of up to 5% of the company's average daily turnover until it supplies the required data<sup>7</sup>.

Application of the EU competition rules to the insurance sector may have far-reaching consequences in the event of an infringement, including:

- the imposition of a fine of up to 10% of the company's annual turnover<sup>8</sup>;
- legal actions for damages and/or interim measures in national courts;
- unenforceability of contractual obligations; and
- serious damage to a company's reputation, rating and share price.

It is important to note that there are no criminal sanctions for infringement of the EC competition rules on a European level, although these might well exist under national legislation.

## 6. Case study

Rather than apply severe sanctions, the Commission has power to decide that its objectives are better served by co-operating with the industry under investigation. In the most recent insurance case to be considered by the Directorate General for Competition, the Commission announced that it had accepted commitments by leading European aviation insurers to reform their practices in order to promote competition and transparency in the sector.

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<sup>6</sup> Council Regulation 1/2003, Article 23.

<sup>7</sup> Council Regulation 1/2003, Article 24

<sup>8</sup> Council Regulation 1/2003, Article 23.

These commitments were the result of an investigation by the Commission into the industry's practices in the aftermath of 11 September 2001 and whether these practices breached European competition rules. The Commission did not indicate that there was a breach of European competition rules but did conclude that some of the industry's structures for cooperation were restrictive and that safeguards against excessive coordination among insurers could enhance competition.

These commitments were given by the International Underwriting Association of London and the Lloyd's Market Association, and bind their members. They included commitments:

- to introduce consumer input to standard clauses devised by industry committees for aviation insurance policies by way of the establishment of an Aviation Insurance Clauses Group. The new Group will give customers the opportunity to be consulted on proposed clauses and to propose new wording, clauses or variants;
- to introduce more transparency into the setting of such clauses by ensuring the publication of records of the Group's meetings;
- to limit co-ordinated action by replacing the previous body where the two associations met to discuss matters of common interest, with a new body, the Aviation Liaison Forum, with more stringent terms of reference and a clearer remit; and
- to limit co-ordinated action in situations of crisis - e.g. resulting from war or terrorism - to that which is indispensable to ensure continued availability of capacity and insurance cover; the effects on competition from such action will be kept to a strict minimum by the adoption of a new Crisis Response Protocol.

The Commission decided not to pursue its investigation any further as the undertakings offered had adequately addressed its concerns. However, it announced that it will "...continue to monitor market developments and keep the aviation insurance market under close scrutiny".

This result is neither ground-breaking nor unexpected. Indeed, the aviation case echoes the resolution of the International Group of P&I Clubs (the "IG") case<sup>9</sup> where the Commission found that a pooling agreement was not in breach of the European competition rules and the IG Agreement was exempted under Article 81(3) (then Article 85(3)). That decision was only adopted after lengthy negotiation and substantial concessions by the IG, which lowered the common level of cover offered and clarified that P&I Clubs are free to provide different levels of cover outside the Pooling Agreement, thus increasing competition between its members. The IG also modified the IG Agreement, allowing more competition on rates between individual P&I Clubs and increased transparency and comparability of a P&I Club's administrative costs.

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<sup>9</sup> Commission Decision of 12 April 1999; Cases No IV/D-1/30.373 - P&I Clubs, IGA and No IV/D-1/37.143 - P&I Clubs, Pooling Agreement.

## 7. Conclusion

The Commission's inquiry will not be limited to private obstacles to competition and so will also study regulatory and legislative barriers; commercial insurers must therefore be prepared for a thorough shake up of their market. The inquiry will include the business practices of the market players and, at best, is likely to attempt to inject more competitive and transparent methods and procedure into the markets. In the worst case scenario, it will result in findings of breaches of the rules by market players (insurers, intermediaries, reinsurers, etc.).

Commercial insurers must be ready for all eventualities. In the first instance, it is important to be prepared to respond to the Commission's questionnaires adequately, as the provision of incorrect or out of time replies may lead to significant fines.

In the later stages of the inquiry, insurers must also be ready for any outcome, from being found in breach of competition rules to regulatory or legislative change. In the first case, by being prepared for investigations or even findings of infringement, insurance companies will contribute to effective damage control. In the second case, by ensuring that they anticipate legal and regulatory change, they will significantly improve their competitive position. Initial suggestions to ensure compliance are set out in our first Briefing on this matter, dated 18 March 2005<sup>10</sup>.

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<sup>10</sup> For link, see footnote 1.