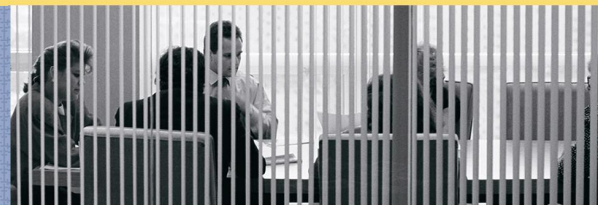


EU INSURANCE BRIEFING



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EU Commission Inquiry Into Insurance – The Final Report

Directorate-General Competition of the European Commission has recently conducted an inquiry into competition in the business insurance sector. The Commission's Final Report was published on 26 September.

The Final Report raises strong concerns in relation to three key areas:

(1) Co-insurance

The Commission is concerned by the practice of the leading insurer's premium being disclosed to following insurers.

(2) Brokers

The Final Report highlights systemic conflicts of interest where brokers act both for insureds and insurers. One particular area of focus is broker remuneration, and the Commission considers that disclosure of remuneration does not, in itself, resolve the conflicts.

(3) Block Exemption Regulation

The Commission is not currently persuaded that there are good reasons to justify renewing the Block Exemption Regulation relating to insurance in 2010.

The Final Report urges the industry to review these issues, and backs this with a threat of enforcement action.

Introduction

In June 2005, the European Commission launched a sector inquiry into business insurance. Following an Interim Report in January, the Final Report was issued this Wednesday. It is surprisingly shy of reaching final conclusions, but it makes strong assertions in relation to three key areas, and it is clear that the Commission is looking for improvements in industry practice.

Financial Analysis

In its Interim Report, the Commission expressed the view that the insurance industry is generally highly profitable but that it has some "*striking*" geographical and product variations and discrepancies. Some insurers have criticized the methodology used by the Commission to reach this conclusion. The Commission accepts some of those criticisms, but states that the "*general picture painted by the Interim Report remains unchanged*".

The profitability of reinsurance companies is still under review and will be the subject of an addendum to the Final Report.

Co-insurance

The first substantive issue covered in the Report relates to co-insurance (and co-reinsurance), and is of great relevance to the London market. The Commission acknowledges the benefits of co-insurance in general, but states that it "*has found*

evidence which suggests that some practices prevalent in parts of the market might fall within the scope of Article 81(1)". This provision prohibits anti-competitive agreements between competitors, and breach of it can give rise to potentially massive fines.

The Interim Report questioned the legality of "*best terms and conditions*" ("BTC") agreements, and that concern is repeated in the Final Report. As most insurers and reinsurers have stopped using such agreements, this may be of relatively little practical concern.

However, the Commission has now dug further. Apparently without having consulted the sector, it alleges that in co-insurance and reinsurance markets there is "*almost always ... a de facto alignment of premiums and other conditions of coverage independently of the use or otherwise of BTC clauses*". The main concern appears to be with the sharing of pricing information, which the Commission believes may amount to an unlawful exchange of information and price fixing. To escape liability, co-insurers would have to show that such an exchange of information was objectively justified and was indispensable.

This has particular ramifications for the London market, in which complex insurance programmes are underwritten using a subscription market to provide large amounts of capacity quickly. Until now, some following insurers have taken into account the pricing of the leading insurer when setting their own premium. However, brokers and insurers are now effectively on notice that if they share pricing information in this way, they may find themselves at risk of allegations of price-fixing.

The inference is that each insurer should make its own independent evaluation of the appropriate premium to charge for any given risk, even if it is being asked to take only a very small line. One possible result of this could be a contraction of capacity, with some insurers being less willing to take lines

in areas in which they have limited expertise. Alternatively, insurers may choose to write business outside their core areas of expertise, but with a less sophisticated understanding of pricing than the leading insurer, giving rise to under-charging or over-charging, neither of which is likely to be in the long term interest of insureds. A third possible result is that large amounts of underwriting information will have to be distributed to more insurers than at present, which could potentially slow down the placing process.

Although insurers are urged to review their current practices, they can at least breathe easy that the Commission is not proposing to bring action in relation to legacy practices.

Brokers

The Final Report also raises serious concerns regarding brokers.

In this regard, most attention is given to remuneration. The Commission suggests that remuneration is currently often structured in a way which encourages the broker to direct business to insurers based on the broker's own interest, rather than to provide the best deal to the insured.

Previous efforts of the FSA and other regulators in this area have tended to focus on a duty to disclose the amount of the remuneration received by the broker. However, the Final Report states that it is "*questionable*" whether disclosure alone gives enough protection. It notes that insureds have "*seemingly low concern*" about brokers' remuneration, but suggests that this may be because they do not actually realise how much brokers are paid. The Final Report makes no definitive recommendations, but the implicit preference of the Commission would seem to be that brokers' fees would be agreed between the broker and the insured, without involvement of the insurer.

The Final Report also raises a much broader concern, that brokers have actual or potential

conflicts of interest when they act on behalf of insurers as well as insureds. This is a matter which has given rise to some tricky legal questions in the past, and no doubt poses problems for brokers in practice. Again, no specific recommendations are made in this regard.

However, the Final Report flags these as issues for consideration in the forthcoming review of the Insurance Mediation Directive, and it is clear that the Commission will return to them in future. Brokers and insurers therefore have a “heads up” that these issues will surface again in due course, and it would be prudent to consider now to what commercial steps can be taken to preempt them.

Block Exemption Regulation

A third issue attracting the Commission’s attention is the Block Exemption Regulation (“BER”). Article 81(1) of the EC Treaty prohibits anti-competitive agreements, but the BER grants an exemption for certain forms of insurance and reinsurance cooperation agreements such as the sharing of some historical claims data.

The Commission notes that the majority of respondents support the BER and regard the forms of cooperation exempted by it as justified. However, its response to these submissions is that, even if cooperation arrangements are desirable and competitive, that does not mean that the legal instrument of a block exemption is required. This disregards the practical benefits (in terms of cost, certainty and time) which flow from insurers’ not having to justify each arrangement individually.

The Commission implies that insurers must assess the merits of each arrangement for themselves and be prepared to defend their view that the arrangement is not anti-competitive, using general competition rules.

The Commission considers that the inquiry has shown that business insurers do not seem to need a tailored BER and are

perfectly capable of self-assessing the legality of their agreements.

The BER will expire on 31 March 2010 unless it is renewed. The Commission states that it will give further consideration to this issue by March 2009, but that at present it sees no “*compelling reasons*” for renewal. Given the general trend of Community competition policy, insurers will have an uphill struggle to maintain the BER.

Conclusion

The Final Report discusses three important areas, namely pricing by leading/following insurers, the role of intermediaries, and the Block Exemption Regulation. In relation to these areas, it “*invites the parties concerned ... to carry out their own assessment and to engage in a dialogue with a view either to clarifying whether these practices are compatible with competition law, and/or to reviewing the practices in question*”. It also asks for feedback from the industry, but does not give any deadline for such feedback.

These invitations are backed up with the message that the Commission “*will not hesitate to make use of its enforcement powers*” if it has to do so. In other words, the Commission is using the approach of an iron fist in a velvet glove. Experience in parallel sectors, such as banking, shows that the Commission is willing to take enforcement measures if active steps are not taken to deal with its concerns.

That approach is remarkably similar to the one taken by the FSA in relation to contract certainty. On that issue, the market was able to take action to the regulator’s satisfaction. It appears that the gauntlet has been thrown down once again.

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