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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Final Report)

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1. INTRODUCTION

1. The Commission decided on 13 June 2005 to initiate a sector inquiry into the provision of insurance products and services to businesses in the Community, based on Article 17 of Council Regulation (EC) No 1/2003. Taking into account indications that competition in this sector within the common market may be restricted or distorted, the sector inquiry aimed at further investigating the sector and the practices concerned with a view to ultimately identifying any concrete restrictive practices or distortions of competition that may fall within the scope of Articles 81 or 82 of the Treaty. Business insurance includes, *inter alia*, coverage for property risks and business interruption; shipping; motor vehicles; general, professional and environmental liability; personal accidents and credit risks.

2. This document is the final report of the business insurance sector inquiry[1], and is being released together with a comprehensive working document of the Commission's services containing the full findings (the Working Document). The earlier Interim Report and the Working Document contain an extensive account of how insurance markets are organized in the EU, including a good deal of original research by the Commission conducted during the inquiry. A public hearing to discuss the findings of the Interim Report was held on 9 February 2007. The report was open for public consultation and received ample attention from industry stakeholders. All non-confidential submissions have been published on the Commission's website.

3. This Final Report and the Working Document focus on a number of key issues and concerns. The omission of any issue in this Report does not imply that the Commission has a priori excluded possible concerns in other areas of business insurance.

4. Insurance is of vital importance for big and small businesses throughout the European Union. The ability to insure given risks may make or break a particular business model. Many of the world's most important and iconic industries, from aviation and shipping to major real estate developments could not function without insurance, and when insurance markets lack the capacity to insure risks this has a knock-on effect on the whole economy. EU insurers collect € 375 billion in non-life premiums every year[2]. European insurers and reinsurers are also very active in international markets, and they are major investors in capital markets. Accordingly,

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1 The Interim Report was published on 24 January 2007.

2 Source: Swiss Re, Sigma 2/2005, p. 39 and 5/2006, p. 35; cf. Interim Report, p. 37.

the functioning of this industry in a pro-competitive way is not only crucial for the insurance industry as such, but for the economy as a whole. Through this report, the Commission's intention is to contribute to an even more competitive, dynamic and profitable European insurance industry able to play its full role in the economy and fulfil its potential in the European Union of the 21st century.

5. With the exception of large customers and risks, primary insurance markets tend to be national in scope, even when they are primarily served by consolidated multinational insurance groups. This is for a variety of reasons, of which the most important is probably the fact that insurance contracts are written under, and subject to, general national contract law as well as specific insurance law, and that liability issues also arise under national law which may substantially vary from one jurisdiction to another. In addition, there is a need for some form of local presence, often for distribution and always for claims settlement, and language issues may arise. It is natural thus to characterize the organization of the market as multi-domestic and to exclude, in many cases, the possibility of any competitive constraint from cross-border providers short of actual entry. The mode of entry for insurers seeking to enter new markets has, to date, usually been through acquisition of a local company which becomes a subsidiary or (in a few cases) a branch of the acquirer. National markets tend as a consequence to be quite concentrated, especially in the major categories of risk.

2. MAIN FINDINGS OF THE SECTOR INQUIRY INTO BUSINESS INSURANCE

2.1. Financial aspects of the industry

6. The Commission gathered a range of data on insurers' financial performance. The preliminary results suggest that profitability in business insurance at the EU-25 level has been sustained over recent years in the majority of Member States, albeit with significant variations[3]. It has been argued by the industry, however, that, due to the insurance business cycle, a longer term perspective would be needed to fully assess profitability. Many industry participants also claimed that there were a number of other methodological weaknesses in the Commission's approach. Some of these criticisms were valid, and the Commission has revised this section of the Working Document to take account of these remarks. However, the general picture painted by the Interim Report remains unchanged.

7. Underwriting profitability varies significantly both in terms of business lines and Member States. Profit ratios vary by a factor of one to three across the EU-25 for the same insurance line and by up to double within the same country for different insurance lines[4]. While it is acknowledged that the risk covered by underwriting is different in the different lines, and therefore the return on capital demanded may be also different, the magnitude of these discrepancies is striking. There are also wide variations in insurers' income for specific product lines within the same country.

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[3] Bulgaria and Romania were outside the scope of the inquiry.

[4] Interim Report, ch. VI; Working Document, ch. II.

8. Insurers' profitability varies significantly across the EU-25 according to whether customers are SMEs or large corporations. In a few cases, certain Member States seem to consistently display higher underwriting profitability in the SME segment. It has been suggested that this might, in some instances, be related to the mode of remuneration of intermediaries by insurers, the suggestion being that when brokers have market power, insurers may bid up broker commissions in order to capture business. However, this would need to be verified on a case-by-case basis.

9. The analysis which the Commission has carried out is probably most significant when it comes to underlining market fragmentation and the scope for savings from further integration. There are many factors which fragment insurance markets and defy any simplistic analysis. The Commission may wish to look further at these factors and propose additional measures to encourage greater market efficiency at the pan-EU level.

10. The Commission also collected information relating to the profitability of reinsurance companies but, for methodological reasons, is not yet in a position to report on this aspect of the inquiry. It intends to do so via an addendum to the Working Document.

2.2. Harmonization of terms and conditions in coinsurance and reinsurance

11. Both co-reinsurance and coinsurance are important mechanisms underpinning the EU insurance industry and the insurability of large risks. The existence of mechanisms allowing multiple (re)insurers each to take a part of a given risk plausibly allows for greater capacity and risk diversification and results in lower prices and better terms for clients. However, whilst acknowledging these benefits, the Commission has found evidence which suggests that some practices prevalent in parts of the market might fall within the scope of Article 81 of the Treaty.

12. In the Interim Report, the Commission drew attention to a practice in the market for joint reinsurance of including a clause intended to guarantee that a given reinsurer obtained terms no less favourable (from its standpoint) than those offered to any other reinsurer participating in the contract: the so-called "Best terms and conditions" clause (BTC). The Commission also noticed that this practice appeared to surface in a similar form in the coinsurance market.

13. The Commission expressed the view in the Interim Report that the practice of BTC was likely to be to the detriment of the respective customers and might, under certain conditions, amount to a restriction of competition within the sense of Article 81(1) of the EC Treaty. The Commission did not, at that time, advance a view as to the possible exemptability of the clause under Article 81(3). It undertook, however, in the second phase of the inquiry, to take a closer look at this type of practice and solicited views from the market on it.

14. It appeared during the first phase of the inquiry that BTC clauses did not necessarily appear as such in the final (re)insurance contract but could, for example, be introduced at quote stage and thereby relate exclusively to the process whereby co-(re)insurance arrangements were negotiated and drawn up. As a result of its investigation, it soon became clear to the Commission, however, that widespread practice in both reinsurance and coinsurance markets almost always results in a *de*

facto alignment of premiums and other conditions of coverage independently of the use or otherwise of BTC clauses. Accordingly, the Commission widened its analysis to include all mechanisms which lead to such an alignment, whilst recognizing that the BTC clause may result in even less favourable terms for clients than when it is not employed.

15. The Commission's provisional view of the practices described is that individual instances of them, when they result from agreements between undertakings, may fall within the scope of Article 81(1). Furthermore, the Commission has not been provided at this stage with persuasive arguments to justify their indispensability as required by Article 81(3). Obviously, assessing the fulfilment of the conditions of Article 81(3) will have to be done on a case-by-case basis and against the relevant factual and legal context. The practices of revealing the price of the lead insurer in the subscription phase, guaranteeing the lead insurer's share and aligning the terms of cover other than the premium are less likely to raise concerns from a competition law standpoint or are more likely to fulfil the conditions for exemption.

16. The Commission is aware that these practices have been considered normal market practice in certain markets for a considerable time. The Commission nonetheless believes that, in the light of its findings, the industry should engage in a critical reappraisal of the said practices. It intends to play a full role in this process whilst duly observing the principle that it is to market participants themselves to assess the legality of their market practices under the applicable legal standards.

17. The Commission stresses that its observations relate only to elements of certain business practices which arise in the two-step subscription procedure and which it believes not to be essential to the operation of that procedure, and still less of the market as a whole. It also invites the customers of business insurance and reinsurance which is typically awarded on a subscription basis to be aware of the possibility of awarding such business on terms which do not imply harmonized premiums and to ensure that wherever this is appropriate, this option is fully explored by risk managers and brokers. The Commission is not raising any concerns in the Report about other ways of awarding co- and reinsurance business, which include vertical marketing, ad hoc syndication between insurers and standing arrangements such as pools. Whether in individual instances the use of these procedures might give rise to competition concerns would require a case-by-case analysis.

2.3. Distribution of business insurance

18. The Interim Report provided a detailed overview of the main aspects relating to the distribution of business insurance products and services in the European Union. Insurance is distributed through independent brokers, tied agents, banks (so-called bancassurance) and direct sales, including internet sales. Brokers, tied agents and direct sales account for the vast majority of sales. The need to build a distribution network may be a barrier to entry in the absence of a strong independent brokerage network available at national level.

19. 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 is a potential source of conflict of interest between the objectivity of the advice they

provide to their clients and their own commercial considerations. Such conflicts of interest can also arise from a number of sources linked to their remuneration, including contingent commissions.

20. In respect of insurance intermediaries, the market surveys and the public consultation highlight the fact that current market practices - in particular the lack of spontaneous disclosure of remuneration received from insurers and other possible conflicts of interest - create an environment in which business insurance clients, in many cases, are unable to make fully informed choices.

21. Practices aimed at inciting brokers to place business with particular insurers have the potential to undermine fair competition in the insurance market around terms and conditions of cover, service and insurers' financial strength. Such practices might, instead, result in insurers' competing against each other on the level of remuneration afforded to brokers in an attempt to "buy" distribution, or at the very least influence the broker's choice.

22. Disclosure of relevant information by intermediaries, in relation to remuneration received from insurers and services provided to insurers, may help mitigate conflicts of interest. At present, even where disclosure takes place, it does not always appear to be complete, clear and understandable to the client. In the light of similar situations that arise in other financial sectors, notably in securities and banking, it is questionable, however, if disclosure alone is sufficient to mitigate conflicts of interest, in particular in relation to those types of remuneration that specifically aim at aligning the interest of brokers with that of insurers.

23. The Interim Report also explained that the prohibition by insurers of commission rebating could amount to resale price maintenance and, as such, would 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 sense of Article 81 of the Treaty.

24. Market surveys conducted in three Member States and the public consultation have not produced evidence as to the existence of private agreements or practices acting to prevent or discourage independent insurance intermediaries from rebating commissions to their clients. However, responses submitted by Italian brokers indicate certain confusion as to the broker association's policy in relation to commission rebating and suggest a need for further clarification. In Germany, this practice continues to be prohibited by national law.

25. At present, the competitive market dynamics in relation to the price of mediation services appear limited, at best, as far as SME clients are concerned. The seemingly low concern of SME clients with the price of insurance mediation services may perhaps be due to a common misconception as to the amount of commission (and possibly other types of remuneration) actually paid to the intermediary included in their insurance premium, which is typically higher than is realized.

26. The Commission believes that this issue, although potentially leading to serious concerns of market distortion, has multiple dimensions which require careful consideration. It intends to look at the issue in the framework of the planned review

of the Insurance Mediation Directive, without, however, at this stage prejudging whether this is the most appropriate way to address it. When assessing the most appropriate answer to this issue, the Commission will also take into account the treatment given to similar situations in other sectors, in particular the MiFID regime for investment services, in order to ensure regulatory neutrality.

2.4. Horizontal cooperation amongst insurers

27. Some forms of cooperation between insurers are at present block exempted by Regulation (EC) No 358/2003[5]. The current Block Exemption Regulation (BER) was adopted with a validity of seven years and will thus expire on 31 March 2010. The sector inquiry noted that actual use of the BER varies significantly from one Member State to another, and sought to establish views on the future of this regime insofar as it applies to business insurance.

28. In their responses, industry stakeholders usually observed that the forms of cooperation and agreements exempted by the Block Exemption Regulation are pro-competitive. Several respondents suggested that the absence of market-wide historical risk information or the unavailability of standard conditions (with an associated case law interpreting their scope) were barriers to entry in certain markets. During the consultation, few respondents raised concerns with respect to the forms of cooperation covered by the BER, with the exception of some comments relating to the operation of downstream markets such as for security devices.

29. The vast majority of respondents, at least from the insurance community, were very much in favour of prolonging the current Block Exemption Regulation when it expires in 2010. Several respondents argued that the Commission should, in any case, not draw any firm conclusions as regards the future of the BER from the results of the Sector Inquiry, given that the latter only covered business insurance whereas the BER is wider in scope. Some respondents disputed, however, that the insurance industry needs a special treatment under antitrust rules.

30. The Commission recognizes the attachment of many in the industry, especially insurers, to the BER. However, almost all replies failed to make a distinction between the desirability of the forms of cooperation covered by the BER, and the desirability of the BER itself. In this context, it is necessary to recall that the objective of the BER before the entry into force in May 2004 of Regulation (EC) No 1/2003, was to exclude certain generic types of agreement from the ambit of Article 81(1), thereby obviating the need for separate and time-consuming individual exemptions. Since that time, there is no longer any requirement on undertakings to notify forms of cooperation to the Commission which may fall within the scope of Article 81(1) in order to obtain a decision exempting those forms of cooperation under Article 81(3). Rather, undertakings should themselves assess the compatibility of their behaviour with the competition rules, aided as necessary by external counsel and other advisors.

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[5] 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 (OJ L 53, 28.2.2003, p. 8).

31. It may be argued that, in the light of Regulation (EC) No 1/2003 and on the basis of the experience accumulated in relation to the different forms of cooperation permitted under the BER, at least as far as business insurance is concerned, market participants no longer need a form-based sectoral block exemption and should be able to conduct their own self-assessment of the application of Article 81(3) as in other sectors. On the other hand, there is a risk that the BER on occasion inadvertently exempts certain forms of cooperation which may have anticompetitive effects, particularly in the related markets for security devices.

32. The Commission itself would point out that, even absent the insurance BER, the insurance industry would continue to benefit from the terms of the horizontal and vertical Block Exemption Regulations[6].

33. This discussion will continue, since under the terms of the enabling legislation the Commission is required to submit, by 31 March 2009, a report on the functioning and future of the BER[7]. Industry participants and other interested stakeholders are therefore very much encouraged 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 which it covers.

2.5. Duration of business insurance contracts

34. During the Sector Inquiry, the Commission looked at the duration of contracts and at clauses concerning their renewal and extension, because of the competition concerns that a general practice of excessively long-term contracts might potentially raise in terms of foreclosing the market to new entry[8]. If customers are committed with the same insurer for a long period, this could affect competitors who are trying to gain access to the market or to increase their market share. This might happen when long-term agreements combine with other factors to have a cumulative effect on competition, such as the number of similar contracts, their duration, the share of the market that this type of agreements covers, the degree of market saturation and customer loyalty. Such concerns were also raised during the Sector Inquiry by some market participants, in particular in relation to Austria and Italy.

35. In order to avoid misunderstanding, the Commission would like to emphasize that, in principle, it is concerned with the potential exclusionary effect of long term contracts

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6 Council Regulation (EEC) No 2821/71 on application of Article 85(3) [now 81(3)] of the Treaty to categories of agreements, decisions and concerted practices (OJ L 285, 29.12.1971, p. 46); Commission Notice - Guidelines on the applicability of Article 81 to horizontal co-operation agreements (OJ C 3, 6.1.2001, p. 2); Council Regulation (EC) No 1215/1999 of 10 June 1999 amending Regulation No 19/65/EEC on the application of Article 81(3) of the Treaty to certain categories of agreements and concerted practices (OJ L 148, 15.6.1999, p. 1); Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (OJ L 336, 29.12.1999, p. 21); Commission Notice - Guidelines on Vertical Restraints (OJ C 291, 13.10.2000, p. 1).

7 Article 8 of Council Regulation (EEC) No 1534/91 of 31 May 1991 on the application of Article 85(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector

8 In Austria the average duration of contracts was calculated as approximately eight years (101 months), in Slovenia almost seven years (81 months), in Italy approximately six years (73 months), and in the Netherlands, approximately six years (79 months).

under competition law when their cumulative effect causes market foreclosure. A concern might also arise if the practice were carried out by a dominant company with the object or effect of preventing or limiting competition.

36. Whilst the Commission is able to intervene under competition rules in certain circumstances, this is not always the preferred route. In the present instance, the Commission believes that it would be appropriate to consider the situation in Austria further, without prejudice to the route that this might take. In the case of Italy, recent regulatory intervention appears to have changed the environment such that long-term contracts should no longer be susceptible of generating foreclosure.

3. CONCLUSIONS

37. The sector inquiry identified three key issues that will need to be followed up by the Commission and/or national authorities:

- Certain practices leading to premium alignment when coinsurance and reinsurance is purchased through a two-step procedure involving a lead and following (re)insurers;

- Instances where a pervasive market practice of long-term contracts may lead to cumulative foreclosure; and

- Indications of potential market failure in respect of insurance brokerage.

38. The Commission invites the parties concerned by the various issues identified to carry out their own assessment and to engage in a dialogue with a view either to clarifying whether or not these practices are compatible with competition law, and/or to reviewing the practices in question.

39. The Commission will not hesitate to make use of its enforcement powers under competition law if necessary. Clearly, any possible enforcement procedures would require a full examination of the specifics of each case in consultation with the national competition authorities. The Commission also invites market participants to come forward with further evidence of abusive practices, on a confidential basis if necessary.

40. In respect of insurance brokerage, the Commission intends to look at these issues anew in the framework of the review of the Insurance Mediation Directive, but also invites Member States and industry participants to review the Commission's findings and propose appropriate action themselves.

41. Finally, in respect of the Block Exemption Regulation, the Sector Inquiry has not produced compelling reasons, as regards business insurance, to prolong it beyond 2010. However, the Commission will review this matter definitively in view of a report by March 2009 as the enabling legislation requires.

42. The Commission welcomes further comments on the report, which should be sent to the email address: Comp-Sector-Insurance@ec.europa.eu.