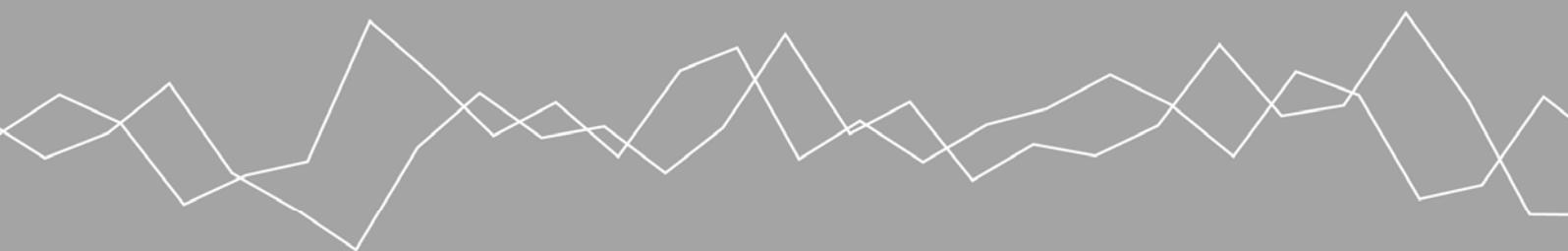


Information on the Dutch coinsurance market



Amsterdam, February 2008
Commissioned by VNAB

Information on the Dutch coinsurance market

Reaction to the EC DG Competition sectoral inquiry on business
insurance

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Appendix A Literature

Executive summary

This note aims at addressing some of the issues raised by the European Commission (EC) in their sector inquiry on business insurance with regard to the Dutch coinsurance market. More specifically, we discuss:

1. The competitiveness and efficiency of the Dutch coinsurance market: Is the customers' interest best guaranteed? How do the various pools increase the efficient functioning of the Dutch coinsurance market? How important is the innocent capacity?
2. The central position of the broker on the Dutch market: Is conflict of interest and (in)transparency of remuneration a (competition) problem?
3. The different character of the Dutch coinsurance market: Is there a national relevant market?

The coinsurance market

Coinsurance is a business-to-business market relating to non-life insurance. Coinsurance occurs where numerous insurers jointly underwrite a risk. Every participant underwrites part of this risk, as the risks involved are too large and too complex to be handled by a single insurance company. On average, 2.9 insurers underwrite one policy.¹ The coinsurance sector is commonly divided in three segments: brand (property), transport (marine) and varia (casualty) with market shares in the coinsurance market in 2006 of 42.6%, 32.6% and 24.8%, respectively. The market share of the coinsurance market in the total business insurance market is 38.3%.

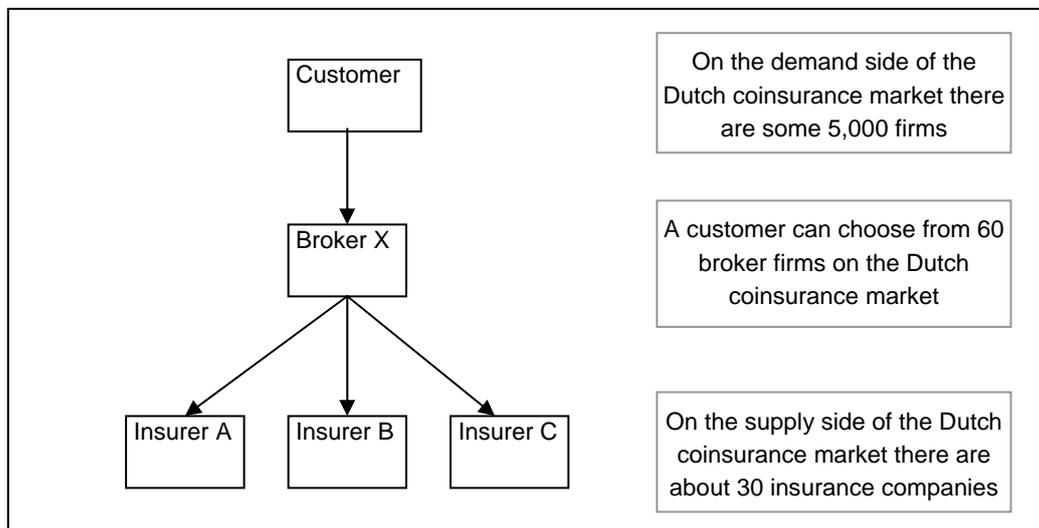
In case of risks that are not too complicated or too large, customers can deal with a single insurance company. There are several distribution channels for these insurance products. In the case of direct writing, customers and insurance companies deal directly. In the provincial channel, customers use an agent or broker to select an insurance company. In both direct writing and provincial insurance, the insurance company structures the policy. On the other hand, in the coinsurance market single risks are split, and insured by more than one insurance company. In about half of the transactions that took place on the *Beurs Clearing System* (BCS, Insurance Exchange Clearing System) in 2006 (representing a quarter of the premium volume), the policy is underwritten by a single insurer. These transactions look like transactions in the provincial channel, but they are different. The role of the broker differs significantly between coinsurance on the one hand and direct writing and the provincial channel on the other hand: in the coinsurance market, the broker structures the policy and in the provincial market this is done by the insurer.

Scheme I gives an overview of the market participants. The market participants are 30 insurance companies (we use this term to refer to underwriting agents as well), 60 brokers and 5,000 medium sized and large firms with large and complex risks. The coinsurance market can be divided into two different client segments: (1) multinationals and (2) medium-sized firms. For the second segment, having a risk underwritten by a single insurer on the provincial market may be an alternative to the coinsurance market. In that case brokers will examine possibilities for their customers both on the provincial market and on the coinsurance market.

¹ Including the 100% market (the market for coinsurance policies underwritten by a single insurer).

Other important stakeholders are the Dutch regulators (Authority for the Financial Markets – AFM; De Nederlandsche Bank – DNB, the Ministry of Finance) and the EC. The insurance exchange association, VNAB, is a self-regulating body and facilitates the efficient functioning of the coinsurance market, i.e., by designing standards for insurance exchange policies.

Scheme I: Overview of the market participants



Source: SEO Economic Research

No high barriers of entry

The number of brokers has been stable during the past decade, whereas the number of insurers is decreasing, especially since 2003. Some dynamics – entry and exit as well as mergers – in the number of players exists. Apart from legal requirements, the most important barriers to entry are membership of the VNAB (which is needed to have access to the BCS (the central clearing system) of the E-Abs)² and knowledge of the Dutch language and market. However, these barriers are not high in the sense that they prevent successful entry in the market. NMa (2005) also notes that the requirements for admission to the insurance exchange are not strict and that the admission procedures do not take long. NMa concludes that: “Both insurers and insurance brokers could easily enter or exit the insurance exchange.”

Also, the duration of the contracts does not imply a barrier to entry. Although the EC seems to suggest otherwise, normally a coinsurance contract lasts for 12 or 36 months (with silent renewal). With NMa (2005), we conclude that policyholders can switch fairly easily.

The broker has the key role in the Dutch coinsurance market

The client who wants to buy coinsurance has to be represented by a broker to participate in the insurance market. Brokers play a key role in promoting competition in the coinsurance market as they bring superior information to the marketplace and help overcome the clients’ search costs. By lowering these search costs and making the market more transparent, brokers make it easier

² Being a member of the VNAB (the Dutch Insurance Exchange Association) is not obligatory, but very common. The total share in the number of BCS transactions of Dutch insurers outside the VNAB and of foreign insurers participating in a Dutch coinsurance policy adds to 7%.

for their customers to switch from one insurer to another. Moreover, brokers may help clients obtain better terms on their policies due to the higher business volume they bring to insurance companies. Brokers also have a function for insurers as they help insurance companies overcome their imperfect knowledge of the precise risk profile of each potential client. For insurers, the existence of brokers as a distribution channel widens the reach of each insurer, which increases the competition in the business insurance marketplace as it increases the choice of suppliers for clients.

In addition to analysing the customer's wishes and negotiating with insurers, the tasks of the broker on the insurance exchange also include:

- Drawing up a risk analysis of the object of the insured, which is presented to the insurers;
- Drafting the insurance cover and possibly drawing up a draft of the policy text which will be presented to the insurers (the so-called cover note);
- Drawing up the coinsurance agreement;
- Collecting the premium. In the property and marine segments, the insurance brokers and not the insurers incur the risk that it will not be possible to collect the premium;
- Handling claims.

When entering into an insurance agreement, there is always one leader³ (except for the 100% market). The group of followers includes three kinds of carriers: would-be leaders that participated in the first stage, would-be leaders that did not participate in the first stage and ignorant followers. These latter insurers don't have the wish, capacity or the knowledge to be leader. Although they make fewer costs because they simply buy into the risk without undertaking the same amount of due diligence as the (would-be) leader(s), their risk is higher because they have to rely on second hand information. Uncertainty about the abilities of the leader is an additional risk for these followers. Followers generally take their decision on the basis of the fact that the lead insurer is willing to underwrite part of the risk. So the reputation of the leader is very important.

The broker facilitates competition among insurers

The broker will run either a formal (private tender) or an informal (broker calls insurers) competition for the coverage of the risk by a lead insurer. He approaches 2 to 4 insurers that could be the leader, and he asks these insurers for a quotation.

Brokers act as senior staff in the sense that they have significant freedom to act within brokers' firms: each of them maintains his own personal network of clients and insurers. Since most brokers' firms employ more than one broker, the personal network of each broker makes the risk of fixed patterns in tendering low. That is, brokers' firms deal with different insurance companies in different tenders (no fixed combinations). The personal networks within the (medium-sized and larger) brokers' firm add up to almost the entire population of insurance companies. Insurance brokerage is a peoples' business. 'Trust' is a keyword in the industry. Firms choose a broker on the basis of mutual trust and on the specific knowledge of the broker. Relations between clients and brokers tend to be long lasting; it is a market of reputations.

³ Sometimes co-leadership occurs, for instance if a risk is split in two and each insurer covers 50% of the risk.

On the Dutch coinsurance market, the proportion of brokers to insurers is 2 to 1. A broker negotiates with on average 5 to 15 insurers (leaders as well as followers) before closing a deal with some of them. The average number of underwriters is 4.9 insurers (implying that the average share of the risk is 20.4%), varying between 5.46 (property) and 3.71 (casualty) (excluding the 100% market). Given the fact that the composition of the insurers involved in a contract varies all the time, the broker has an important role in increasing competition among insurers. The relatively high proportion of brokers together with the fact that fixed combinations do not occur implies that the distribution via brokers guarantees that insurers have to compete intensely.

Insurers underwrite policies at comparable terms and do not directly deal with customers. That may be a circumstance not enhancing competition. However, the role of the brokers, given that there are enough of them in the market, provides competitive incentives for the insurers. Therefore, the competitive fringe (many small brokers who discipline the four or three large ones) is essential. We conclude that as long as the broker market is competitive no competition issues exist. In that respect, it is reassuring that the number of brokers has been stable during the last decade.

Nearly no conflicts of interest

Since brokers work – except for the administrative handling of policies and claims – solely for the customer, they have an incentive to make sharp deals. Conflicts of interest nearly never arise because brokers are not constrained by agreement to refer to one particular insurer and because bonuses and contingent fees play a minor and decreasing role in the Dutch coinsurance market. Moreover, conflicts of interest do seldom occur because the market is transparent (active or passive disclosure of remuneration).

The current practice of premium alignment is not anti-competitive

In essence, the current market practice is for the broker to present the contract agreed between the customer and the leader to the followers, and for the followers to either accept or decline to take a share of the risk on the same terms and conditions (including price) as the leader. The followers can take a share of the risk at the price of the leader or indicate that they only are willing to accept the conditions for a higher price. The latter merely occurs in a hard market.

This mechanism guarantees price competition among insurers (internal competition). On top of that, there is an exogenous cap on coinsurance process: customers can often turn to others insurance companies active outside the coinsurance market (in combination with reinsurance). This external competition increases the competition on the coinsurance market.

Another advantage of the mechanism of alignment of premium and conditions after the leader is selected, is that this mechanism results in an efficient and faster completion of the full coverage of the risk as followers simply have to accept (or reject) the proposed terms and conditions.

Market concentration is not problematic

Although both the insurer's market and the broker's market are moderately concentrated according to the Herfindahl Hirschman Index (HHI), which is a commonly measured of market concentration, this does not have to raise competition problems. For instance, the fact that individual brokers within the firms have important roles, significantly softens the impact of market concentration. Moreover, HHI will be lower if we take into consideration that a number

of the provincial intermediaries sometimes act as producers and as such ‘hire’ coinsurance brokers – who then act as so-called wholesale brokers – to do their deals. Similarly, the impact of market concentration in the insurance market is softened by the fact that that (big) leaders need (smaller) followers to close a deal. Moreover, niche players are active on the insurance exchange, which do not offer all products, but focus on certain types of insurance for which they are strong competition for the big all-round insurers. Third, for medium-sized companies, the provincial non-life market is an alternative to coinsurance; and for the largest firms London and other international markets are an alternative.

The Dutch coinsurance market is efficient

The Dutch coinsurance market is said to be very efficient compared to for instance other national markets. For instance, the Netherlands has the lowest average premium for liability policies premium after the UK (Marsh (2007)). The efficiency of both markets has to do with the central role of the broker on these markets. Other European markets have much higher premiums.

The efficiency of the Dutch coinsurance market is also obvious if we compare it to the provincial market. This comparison is possible because there are some insurers who offer both coinsurance and provincial policies. Based on the interviews and the data we received, we know that the brokers’ fee plus the insurers’ costs add up to somewhat more than 40% of the total gross premium income on the provincial market against less than 25% on the coinsurance market. This is a significant difference in costs between both markets, implying that for large risks coinsurance is more efficient than provincial insurance. This efficiency advantage of the coinsurance market is among others due to the active and central role of the broker, the existence of the shared clearing house and claim handling system and the existence of (commodity) pools.⁴ The latter means that small, similar risks are combined and every year the broker and the insurers negotiate the terms and conditions of the pools, instead of having to negotiate per customer.⁵ The share of volume from the pools is estimated by the interviewees to add to about ten percent of the total coinsurance market.

The Dutch coinsurance market probably is a separate geographic market⁶

Based on the low of the share of foreign risks contracted by Dutch insurers and the low share of risks placed overseas by Dutch customers, perceptions from the interviews as well as the description of the structure of the market we conclude that the Dutch market is a national market. That is not to say that it is a closed market: it is open to foreign insurance companies and brokers. Indeed, some of the largest brokers and insurers active on the Dutch markets are of foreign origin.

NMa and the EC come to remarkably different conclusions

Both the Dutch Competition Authority (NMa) and the EC launched inquiries into the coinsurance market. Although these inquiries both focus on the same period, concentrate on a general market analysis (that is not a case specific analysis), and include primarily structural

⁴ Another kind of pool than the ones in which risks are shared by a fixed combination of a broker and various insurers, may exist for risks that would otherwise be non-insurable even in the coinsurance market, like terrorism and nuclear related risk. Without these pools, there would not be a market for these risks.

⁵ Usually the maximum insured risk is 10 to 20 million Euro.

⁶ We use the term ‘probably’ because we do not have the exact data to quantitatively support this hypothesis.

market characteristics, their conclusions are different. Whereas NMa sees no specific competition problems, but merely states that general competition regulation is important due to risks that are inherent to the character of the coinsurance product (that is, horizontal co-operation between insurers and brokers), the EC concludes that actual competition problems do exist. One possible explanation for this difference in the tone and content of the conclusions is that the analysis in the EC inquiry was based on a less extensive research of the Dutch coinsurance market. Consequently, the EC inquiry, does not reckon or reckons much less with the typical *Dutch coinsurance* market.

To sum up

Dutch coinsurance market is both efficient and competitive. General competition regulation suffices to deal with possible competition risks, and at this moment no actual competition issues exist on the Dutch coinsurance market. The role of the broker is essential in guaranteeing competition between insurers. The Dutch market is unique in that respect, and should therefore be treated accordingly by the EC. Competition authorities (NMa and EC) should especially monitor that the broker market is competitive.

1 Introduction

The European Commission launched inquiries into competition in financial services in June 2005, pursuant to Article 17 of Regulation (EC) No 1/2003. The financial services sector inquiry focused among others on business insurance. This decision was based on concerns that in certain areas of both the writing and distribution of business insurance, competition may be restricted or distorted within the common market (EC (2007)). Part of the business insurance market is the coinsurance market. The final EC report defines this sub-market as follows: Coinsurance puts insurers in a position to offer cover for risks which might be impossible for a single insurer to underwrite alone (because, for example, the risk is too large, is a new risk or an old risk which has become more complex) and, as such, serves to facilitate the ability of a wider range of insurers to be involved in the coverage of large and/or complex risks. So without coinsurance, these large and complex risks could not be insured.

An interim report was published on 24 January 2007 with a public invitation to comment on its findings. Whereas the interim report did not include competition issues related to coinsurance, the final report that was published in September 2007 did contain a number of issues:

- The harmonisation of terms and conditions (same premium for leader and followers): The Commission is concerned that the prevailing practice in the marketplace which excludes participants in the so-called ‘follow market’ from offering lower premiums than that offered by the lead insurer, may not comply with competition law;
- The distribution of business insurance: The existence of certain distribution structures (e.g. networks of exclusive agents) can, under specific circumstances, act as entry barriers. Conversely, the existence of a broker channel can facilitate market entry for foreign insurers. However, the predominant mode of remuneration of agents and brokers, namely commissions paid by insurers, is characterised by the EC by a lack of transparency in respect of the (separate) prices of the insurance cover and of the mediation service, which reduces the scope for competition in the market and is susceptible to creating conflicts of interest that risk to be damaging to the interests of customers and leading to higher prices. This is all the more so in case of contingent fees;
- The horizontal co-operation amongst insurers: On the market for coinsurance, far-reaching co-operation occurs between insurers, where this co-operation varies substantially between insurance lines and from one Member State to another.;
- The duration of contracts: Instances where a pervasive market practice of long-term contracts may lead to cumulative foreclosure.

In this note we address some of these issues raised with regard to the Dutch coinsurance market. More specifically, we discuss:

1. The competitiveness and efficiency of the Dutch coinsurance market: Is the customers’ interest best guaranteed? How do the various pools increase the efficient functioning of the Dutch coinsurance market? How important is the innocent capacity?

2. The central position of the broker on the Dutch market: Is conflict of interest and (in)transparency of remuneration a (competition) problem?
3. The different character of the Dutch coinsurance market: Is there a national relevant market?

We used both desk research and interviews (seven interviews; two with brokers and five with insurers) to answer these questions. We have also benefited from discussions with the VNAB. We studied several policy documents from the European Commission and the Dutch Competition Authority as well as documents from the Dutch coinsurance sector (the list of references is given at the end of this note). We also hoped to find data to be able to quantitatively ground our analysis. However, the availability of data is more limited than hoped for and, consequently, the analysis presented here is mainly qualitative. The data we used are collected by the VNAB (the Dutch Insurance Exchange Association), the Dutch Association of Insurers and SEO Economic Research.

The structure of the note is as follows. Chapter 2 provides an overview of the current practices in the Dutch coinsurance market. We describe the position of the various market participants on the coinsurance market: insurers, brokers, customers and institutional parties. In this chapter we also provide economic analysis and some data to assess the level of competitiveness and efficiency of the Dutch coinsurance market (the first question addressed above). In chapter 3 we give further details on the importance of the position of the broker (we address the second question stated above). Chapter 4 addresses question 3 on the national character of the Dutch market. Our conclusions are presented at the end of each chapter as well as in the executive summary at the beginning of this report.

2 Current practices in the Dutch coinsurance market

Coinsurance is a business-to-business market. Coinsurance agreements only relate to business non-life insurance. The reason for the presence of the coinsurance industry is the existence of risks of considerable size (large amounts have to be paid out in claims), major risks (the probability of claims is high), complicated or one-off risks for which there are no claims statistics (the claims are difficult to predict) and possible long-term effects (the claim only occurs after many years). In such cases, the insurer is not willing or able to underwrite such risks alone. The customer may also wish to have a risk underwritten through coinsurance: after all, the risk that the insurer's obligations will not be met is greater in the case of a single insurer than in the case of a group. Yet another advantage of coinsurance policies is the restriction of moral hazard (EC, January 2007).⁷

This chapter gives a general description of the current practices in the Dutch coinsurance market (section 2.1) as well as a description of the position of the various market participants on the coinsurance market: insurers, brokers, customers and institutional parties (section 2.2 to 2.4). The functioning of the coinsurance market is summarised in section 2.5. Section 2.6 gives further details on the efficiency of the Dutch coinsurance market. The conclusions are given in section 2.7.

Sections 2.1 to 2.4 draw on London Economics (2006), NMa (2005) and the information collected in the interviews.

2.1 General description

Coinsurance occurs where numerous insurers jointly underwrite a risk. Every participant underwrites part of this risk, as the risks involved are too large and too complex to be handled by a single insurance company. A total of 48,200 insurance policies were registered in 2006. On average, 2.9 insurers underwrite one policy.⁸ The various market participants are:

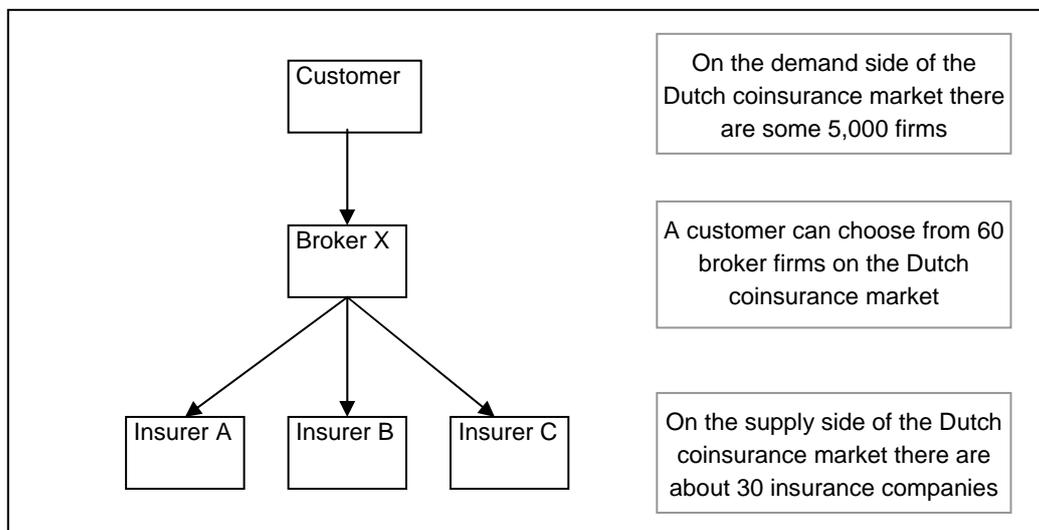
- Supply: insurance companies (we use this term to refer to underwriting agents as well);
- Intermediaries: brokers;
- Demand: medium sized and large firms with large and complex risks.

⁷ In insurance markets, moral hazard occurs when the behaviour of the insured party changes in a way that raises costs for the insurer, since the insured party no longer bears the full costs of that behaviour. To discourage moral hazard, insurers generally seek to restrict cover to losses, which are accidental and restrict payments to an indemnity only – i.e. exact compensation for the loss and no more. Moral hazard can be reduced by a number of standard techniques, among which the exposing of the insured to part of the risk by means of deductibles or coinsurance. Other options are the use of policy conditions to restrict coverage for high risk insured, either in advance of losses occurring or as a consequence of claims experience, and the levying of variable premiums according to risk.

⁸ A fair share of the policies in the coinsurance market is not split, but underwritten by a single insurer (see § 2.1.3).

Scheme 2.1 gives an overview of these market participants.

Scheme 2.1: Overview of the market participants



Source: SEO Economic Research

The supply side of the coinsurance market in the Netherlands consisted in 2006 of at least 27 insurance companies and 54 *active* brokers. For a broker to be termed active he should have participated in 2006 in the *Beurs Clearing System* (BCS, Insurance Exchange Clearing System) and should have been a member of the VNAB (the Dutch Insurance Exchange Association). The actual number of brokers' firms and insurers companies is higher. The list of members of the VNAB consists of 59 brokers and 29 insurers (including 8 underwriting agents) (VNAB, Annual Report 2006). Of these brokers, only 54 made at least one transaction on the BCS. Two insurers merged with, or were acquired by, larger insurers in 2007. Most of the insurers on the Dutch coinsurance market are subsidiaries of foreign insurers.

The demand side of the market for coinsurance services in the Netherlands counts about 5,000 medium-sized and large firms. These firms are considered to be professional customers; larger ones usually have their own insurance or risk manager. There are several ways companies can have their risks insured.

In case of risks that are not too complicated or too large, customers can deal with a single insurance company. There are several distribution channels for these insurance products. In the case of direct writing, customers and insurance companies deal directly. In the provincial channel, customers use an agent or broker to select an insurance company. In both direct writing and provincial insurance, the insurance company structures the policy.

Another possibility is insurance through the coinsurance market where single risks are split, and insured by more than one insurance company. Insurance companies can diversify risks by composing portfolios of policies, leading to a lower risk at constant (expected) revenue. Moreover, they have reduced costs of capital because they experience less volatility. Consequently, coinsurers can offer insurance at a lower price. For the customer the advantages of

the coinsurance market can be the increased degree of certainty and the lower price. This was also recognised in EC (2007).

In about half of the transactions that took place on the BCS in 2006 (representing a quarter of the premium volume), the policy is underwritten by a single insurer. This segment is sometimes called the 100% market. These transactions look like transactions in the provincial channel, but they are different. The role of the broker differs significantly between coinsurance on the one hand and direct writing and the provincial channel on the other hand: in the coinsurance market, the broker structures the policy and in the provincial market this is done by the insurer. So, the tasks of the broker on the insurance exchange are more extensive than those of a broker who mediates on the provincial market between the customer and the insurer.

Also, coinsurance contracts are entered into without going through the BCS. As no public information is available on these contracts outside of the BCS, we are unable to say much about this part of the market, except that is a very small part of the coinsurance market.⁹

2.1.1 Market share of coinsurance market in insurance market

In 2006, the premium recorded on the insurance exchange was approximately 2.1% of the total gross premium income recorded for non-life insurers active in the Netherlands (the total relates to consumer and business insurance).¹⁰ Before 2006 this percentage was two times higher.¹¹

The sector is commonly divided in three segments (NMa (2005)): brand (property), transport (marine) and varia (casualty). Within the transport segment, this involves mainly marine and inland hull all-risks insurance, and goods-in-transit. Casualty covers a number of other types of insurance, such as technical insurance and liability insurance (amongst others liability claims for professional service providers, like notaries), and construction all risks. The market shares of these various segments in the coinsurance market are as follows (based on gross premium recorded on the BCS in 2006):

- Property (439 million Euro): 42.6%;
- Marine (336 million Euro): 32.6%;
- Casualty (256 million Euro): 24.8%.

Since coinsurance is a business-to-business market, the relevant number would be the market share of coinsurance in the total business insurance market. We have constructed this market share based on figures for 2005 provided by the Centre for Insurance Statistics and VNAB.

⁹ All the transactions which go through the insurance exchange are registered by VNAB.

¹⁰ Source: VNAB 2006: The Gross premium recorded on the BCS amounted to 1,031 million Euro. Dutch Association of Insurers, Dutch insurance industry in figures 2007 (p. 46): The total gross premium income in the non-life segment amounts to 48,300 million Euro.

¹¹ In 2005 and 2002, for example, the market share of coinsurance in the total non-life segment was 4.3% and 4.8%, respectively. This is due to a sharp increase in gross premium income in the total non-life segment (around 22 billion Euro in 2002-2005 and 48.3 billion Euro in 2006), while the gross premiums in the coinsurance market are relatively stable in this period (956 million Euro in 2002 and 1,022 million Euro in 2005).

- **Property:** The total gross premium income of insurance companies on property policies in the Netherlands was 3,519 million Euro.¹² A considerable part of this number is related to the consumer market. The Centre for Insurance Statistics estimates that the amount related to the business market amounts to 1,246 million Euro. The gross premiums for property policies recorded on the insurance exchange (as an estimate of the gross premiums received in the coinsurance market) amount to 466 million Euro. So the market share of coinsurance in the Dutch business property policy market is 37.4%;
- **Marine (transport):** The total gross premium income of insurance companies on marine policies in the Netherlands was 681 million Euro.¹³ As most of these policies are related to the business insurance market, we simply take the gross premiums for marine policies recorded on the insurance exchange (307 million Euro) in order to estimate the market share in this segment. Consequently, the market share of coinsurance in the Dutch business marine policy market is 45.1%, however this is an underestimation as some of the 681 million is related to the consumer market;
- **Casualty:** The total gross premium income of insurance companies on general liability/casualty policies in the Netherlands was 1,137 million Euro, of which 740 million Euro was related to business clients and 294 million Euro to households.¹⁴ Since the gross premiums for casualty policies recorded on the insurance exchange was 249 million Euro, the market share of coinsurance in the Dutch business general liability/casualty policy market is 33.6%.

So, the market share of the coinsurance market in the total business insurance market is 38.3%.

2.1.2 Coinsurance versus reinsurance¹⁵

Reinsurance is a method by which an insurance company can protect itself against the risk of losses by taking out reinsurance with other (re)insurance companies. So, reinsurance is insurance for insurance companies. Reinsurance, a highly complex global business. Traditionally, reinsurance transactions were between two insurance entities: the primary insurer that sold the original insurance policies and the reinsurer. Most still are. Primary insurers and reinsurers can share both the premiums and losses or reinsurers may assume the primary company's losses above a certain financial limit in return for a premium. However, risks of various kinds, particularly of natural disasters, are now being sold by insurers and reinsurers to institutional investors in the form of catastrophe bonds and other alternative risk-spreading mechanisms. Increasingly, new products reflect a gradual blending of reinsurance and investment banking.

In the case of large risks, reinsurance can provide an alternative for coinsurance. Coinsurance is often the more attractive option, because it comes with specific and local knowledge. Since the world-wide number of reinsurers is small, reinsurance transaction costs are usually significantly more expensive than coinsurance. Moreover, one needs either a captive insurance company or another insurance company to act as a fronter and therefore we will not discuss further reinsurance in this report.

¹² Source: Dutch Association of Insurers, Dutch insurance industry in figures 2007 (p. 63).

¹³ Source: Dutch Association of Insurers, Dutch insurance industry in figures 2007 (p. 86).

¹⁴ Source: Dutch Association of Insurers, Dutch insurance industry in figures 2007 (p. 96).

¹⁵ This section draws on Insurance Information Institute (2004).

2.2 Position of the client

Coinsurance provides insurance for large risks of medium sized and large firms, of which there are about 5,000 in the Netherlands. Objects insured are for example buildings, contents, consequential loss and goods as well as means of transport (truck fleets, ships, aeroplanes) and liability and constructions. The market is homogenous, although there are some niches. Jewellery, logistics and professional indemnity are mentioned.

According to NMa (2005) the coinsurance market can be divided into two different segments: (1) multinationals and (2) medium-sized firms. For the major and very large risks of large international firms (i.e., Akzo Nobel and Shell), few alternatives exist to coinsurance. These multinationals mainly rely on brokers and insurers that can underwrite or can provide cover for risks throughout the world, and which have an international network. In addition, these multinationals make considerable demands with regard to the rating (financial status) of insurers. The Dutch competition authority concludes that: “This means that for these customers, only five to ten insurers remain who are active world-wide, insure all types and sizes of risk and cover specialist risks, as well as having a sufficiently high rating.”

The second segment consists of medium-sized firms. The risks these firms want to insure are not always so large that a single insurer cannot underwrite them. For these medium sized enterprises, having a risk underwritten by a single insurer on the provincial market may therefore be an alternative to the coinsurance market. In that case brokers will examine possibilities for their customers both on the provincial market and on the coinsurance market. According to the research conducted by NMa (2005) the provincial market is, however, more expensive than the coinsurance market (cf. section 2.3.2).

When asked about the position of the client, all interviewees (both insurers and brokers) respond by explaining the role of the broker. The broker plays a vital role in the coinsurance business. The client who wants to buy coinsurance has to be represented by a broker to participate in the insurance market. The interviewees agree that the brokers work on behalf of and in the interest of the client and that it makes – therefore – little sense to distinguish between the position of the client and the position of the broker.

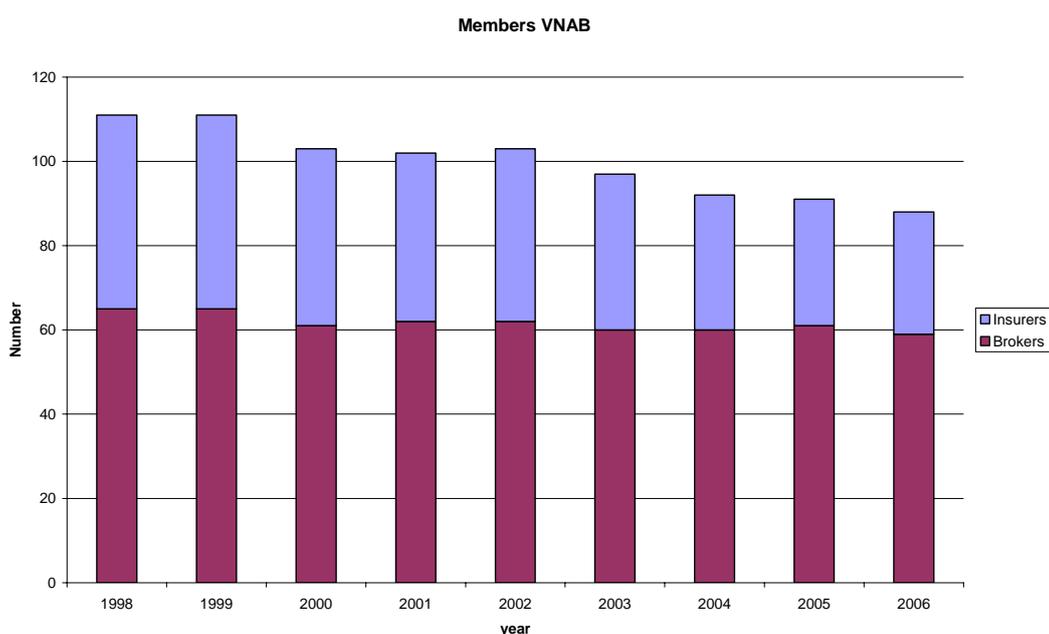
Insurance brokerage is a peoples’ business. ‘Trust’ is a keyword in the industry. Firms choose a broker on the basis of mutual trust and on the specific knowledge of the broker. Relations between clients and brokers tend to be long lasting; it is a market of reputations.

2.3 Supply side: insurers and brokers

2.3.1 Number of suppliers

The number of brokers has been stable during the past decade (Figure 2.1). The number of insurers is decreasing, especially since 2003. Table 2.1 shows that some dynamics – entry and exit as well as mergers – in the number of players exists.

Figure 2.1: Number of brokers and insurers (1998-2006)



Source: The annual reports of the VNAB, edited by SEO Economic Research

Table 2.1: Firm dynamics, insurers and brokers (1990-2006)

	insurers				brokers			
	new	merged	exited	number per ultimo	new	merged	exited	number per ultimo
1990	-*	-	-	52	-	-	-	54
1995	0	0	2	49	6	0	4	68
1998	-	-	-	46	-	-	-	65
1999	3	2	1	46	1	1	0	65
2000	0	3	1	42	1	3	2	61
2001	0	2	0	40	1	0	0	62
2002	2	0	1	41	3	1	2	62
2003	1	2	3	37	5	2	4	60
2004	0	0	5	32	1	1	0	60
2005	0	1	1	30	5	3	1	61
2006	2	0	3	29	2	3	1	59
Total 1999-2006	8	10	15		19	14	10	

Source: The annual reports of the VNAB, edited by SEO Economic Research

* Unknown

Entry barriers

As indicated by the interviewees entry in the broker market is “easy”. The most important requirement is membership of the VNAB, which is needed in order to have access to the central clearing system (E-Abs). Membership of the VNAB is also required for trade on the exchange market (BCS) for both brokers and insurers. Entry in the Dutch coinsurance market for insurers is unanimously considered easy too. There are examples of successful entry in the market. Based on their own research, NMa (2005) notes that the requirements for admission to the insurance exchange are not strict¹⁶ and that the admission procedures do not take long. NMa concludes that: “Both insurers and insurance brokers could easily enter or exit the insurance exchange”.

The relatively short duration of policies (i.e., 1 to 3 years, cf. section 2.4) further implies that is relatively easy for new players to enter the market.

Formal requirements for insurers are:

- Admittance by DNB (Dutch central bank) or the relevant authority in the home country of the insurance company;
- Membership of the VNAB¹⁷, in order to have access to the central clearing system (E-Abs: Electronic Insurance Exchange System). The VNAB-membership entails the following requirements (Article 1 of the VNAB rules):
 - Comply with the legal requirements of the Wet toezicht verzekeringbedrijf 1993 (WTV) and the Wet Assurantiebemiddelingsbedrijf (Wabb);
 - Mandatory participation in the BCS and E-Abs systems.

Formal requirements for brokers are (Article 2 of the VNAB rules):

- A WFT licence, provided by the AFM;
- Membership of the VNAB¹⁸, in order to have access to E-Abs. The VNAB-membership entails the following requirements:
 - A WFT licence, provided by the AFM;
 - A professional liability insurance;
 - Membership of Nederlandse Vereniging van Assurantie Adviseurs en Financiële Dienstverleners (NVA, Netherlands Association of Insurance Advisors and Financial Service Providers) or Vereniging van Onafhankelijke Financiële en Assurantieadviseurs (NBVA, Association of Independent Financial and Insurance Advisors);
 - Mandatory participation in the BCS and E-Abs systems;
 - The following production requirements also apply if one wishes to use BCS: at least 100 broker transactions must be made annually and a gross premium of at least 50,000 Euro must be offered to insurers.

¹⁶ “The production requirement for insurance brokers with regard to the minimum number of entries in the BCS does not appear to be high compared to the average production of insurance brokers already active on the insurance exchange.”

¹⁷ This automatically implies the requirements of membership of the ‘Verbond van Verzekeraars’ (Dutch Association of Insurers).

¹⁸ See footnote 17.

Economic requirements are:

- Solvability requirements, at least the requirements of DNB;
- Expertise in assessing risks (especially for insurers wanting to be leaders);
- Capacity to contract risks.

Informal requirements are:

- Meeting the brokers' standards as it is the broker who determines which insurers are asked for quotations (the larger brokers apply their own rating systems when making their (pre)selection of insurers);
- For the segment of large international customers, the fact that an insurer meets the regulator's solvency requirements is not sufficient and the insurer also has to meet the higher ratings standards of these customers.
- Speaking Dutch: coinsurance is a local game, partly based on personal networks;
- The broker must be familiar with the way in which the insurance exchange works.
- Knowledge of Dutch clients (facts and figures, culture and context).

Exit barriers

From the interviews it appears that opinions on the ease of exit from the market are mixed. The respondents agree that exiting is fairly easy, but that a pattern of exiting and re-entering is damaging for a firm's reputation.¹⁹ Only the very strong brands can get away with that.²⁰ In the interviews, it is mentioned that it is not wise to exit the market as there is a considerable investment needed to (re)start in this market. Mostly insurers will temporarily reduce their activities instead of exit entirely.

Concentration

According to the Herfindahl Hirschman Index (HHI), which is a commonly accepted measure of market concentration, both the insurer's market and the broker's market are moderately concentrated.²¹ However, the HHI based on sixty brokers on the coinsurance market is an overestimate of the market concentration. In practice, part of the provincial market should also be included when determining market concentration. These provincial intermediaries sometimes act as a producer and 'hire' the services of coinsurance brokers, who then operate as a 'wholesale broker'. As these wholesale brokers work for a few hundred provincial intermediaries, the brokers' market is less concentrated than HHI in table 2.2 suggests.

¹⁹ Exiting takes a 'run off period', because of the possibility of long tail claims from existing contracts.

²⁰ Nationale-Nederlanden and Aegon were mentioned several times as firms applying this strategy.

²¹ The Herfindahl-Hirschman Index (HHI) is the squared sum of market shares in a market. The HHI can vary between 0 (perfect competition) and 10,000 (monopoly). For an indication of this measure, consider a market with two suppliers that each have a market share of 50%; the HHI is then 5,000 ($50^2 + 50^2$). When one of the two suppliers is market leader with a market share of 75% and the second supplier has a market share of 25%, the market is more concentrated and the HHI is 6,250 ($75^2 + 25^2$). In the event that there are three suppliers with equal market share (33.3%), however, the market is less concentrated and the HHI is 3,330 ($33^2 + 33^2 + 33^2$).

Often the spectrum of market concentration as measured by the HHI is divided into three regions that can be broadly characterised as not-concentrated (HHI below 1,000), moderately concentrated (HHI between 1,000 and 1,800), and highly concentrated (HHI above 1,800).

On the other hand, the value of 53.7% of C3 in the broker's market, denotes a strong position of a small group of firms. As will be described in chapter 3, brokers' firms act as a kind of partnership, with important roles for individual brokers within the firm. That softens the impact of a high C3-index.

According to NMa (2005) there is only a small group of insurers that offer all types of insurance and have the necessary capacity to accept the risks of large international undertakings. These are, in particular, the German and American insurers: Allianz (German), AIG (American), Zurich (Swiss), Fortis Corporate Insurance (Belgium and Dutch), HDI/Gerling (German), ACE (American), Chubb (American), Royal & Sun Alliance Global and Large Risks (UK), and XL (American). Relatively few Dutch insurers are active on the insurance exchange. NMa estimates their joint market share to be less than 25%. Due to the decrease in the number of insurers and specialisation amongst insurers on the basis of the type of risk, the number of insurers from which companies on the insurance exchange can choose is somewhat limited.

However, the high concentration is softened. First, the fact that (big) leaders need (smaller) followers to close a deal. Moreover, niche players are active on the insurance exchange, which do not offer all products, but focus on certain types of insurance for which they are strong competition for the big all-round insurers. Third, for medium-sized companies, the provincial non-life market is an alternative to coinsurance. NMa (2005) concludes that, as considerably more insurers are active on the total (provincial) non-life market than are active on the coinsurance exchange, a high degree of concentration on the coinsurance exchange does not necessarily indicate that competition is restricted. Moreover, for the largest firms London and other international markets are an alternative.

Table 2.2: Market concentration in terms of number of policies (2006)²²

Index	Brokers	Insurers
HHI	1,576	962
C3	53.7%	42.4%
C5	61.7%	62.6%
C10	76.0%	87.1%

Source: The annual reports of the VNAB, edited by SEO Economic Research

2.3.2 The pooling of risks

Insurance, and certainly coinsurance, is all about risk-sharing. Insurance pools involving a number of insurers are the sole solution for the coverage of large or exceptional risks, such as aviation, nuclear and environmental risks, for which individual insurance companies are reluctant to insure the entire risk alone. An insurance pool is a risk-sharing partnership under civil law formed by legally and economically independent insurers and/or reinsurers in order to create a broader underwriting base for particularly large or unbalanced risks. The members undertake to write certain risks only within the scope of the insurance pool. They include such risks – while maintaining their commercial independence – in the insurance pool against a premium. Each

²² Unfortunately, there are no data on concentration in monetary units (gross or net premium).

insurer participates in the profit or loss of the insurance pool according to its proportionate interest. Reinsurance is often ceded or accepted in order to further diversify the risk.

In (coinsurance) pools, all members take the role of primary insurers according to their interests. In the coinsurance market, two major types of pools are distinguished.

- For risks that would otherwise be non-insurable even in the coinsurance market, like terrorism and nuclear related risk. The risks placed in these pools are very specific. It requires highly specialised knowledge, and thus involves high investments. Firms need to make up long lasting alliances, in order to be able to offer this kind of insurance²³;
- For commodities: pools in which risks are shared by a fixed combination of a broker and various insurers. These are standard contracts with a maximum insured risk of 10 to 20 million Euro.

If anything, the pool strengthens competition since it allows insurers who would otherwise not have been able to provide such cover, to put their resources in common and create a new player.

Commodity pools

Commodity pools exist for the sake of efficiency. Small, similar risks are combined and every year the broker and the insurers negotiate the terms and conditions of the pools, instead of having to negotiate per customer. For policies for commodities with small premiums it is too expensive to place these risks on a per case basis, and it is much more efficient to place them in a pool. The commodity pools include standard risk coverage and standard conditions. If a customer comes to the broker with a risk that fits in the pool, the broker will advise the customer to place that risk in the pool. The price is set per customer. The customer is of course free to ask for additional offers.

The brokers initiate commodity pools. Brokers make a short list based on past experience with insurance companies. From this short list, a leader (and a co-leader) is (are) selected. The leader states the insurance premium, and the co-leader checks this premium. If the broker agrees with the insurance premium, all the participating insurance companies get the same deal. If the broker thinks the premium is too high, he will ask quotations from other firms.

Pools tend to be stable, consisting on one broker and four to eight insurers. In order to avoid transactions costs, the broker strives for stability. As one broke states: “In some years it is possible to find insurers that are willing to take the risks at a lower price, but in the long run, stability pays.”

The share of volume from the pools is estimated by the interviewees to add to about ten percent of the total coinsurance market.

²³ One respondent mentions the Verbond van Verzekeraars as an important factor when starting these pools. Since the Verbond has chosen to cooperate in the terrorism pool, insurers feel obliged to join these pools. Consequently, nearly all insurers join this terrorism pool.

2.3.3 The business cycle: number of policies and premium

According to the interviewees, the market for coinsurance is considered to be highly cyclic, dependent on developments on the global (re-)insurance market and on claims.²⁴ During a cycle the market can be seen as *soft* or *hard*, according to the view of all parties. The market is called soft when competition is intense, a lot of spare capacity is available, prices are low and conditions for the client are good. In times of softness, insurers exit or temporarily withdraw from the market. Because of this exit competition is less intense and capacity will shorten. As soon as the market is hard again, there is shortage of capacity, prices go up and insuring companies (re-)enter the market.

The existence and importance of these cycles is also described in the final report of the EC (2007) and in a report by Marsh (2007). Marsh describes how Hurricane Katrina lead to huge insured losses and a serious loss of windstorm capacity. The dearth of capacity pushed prices up, making the market attractive to new entrants and therefore creating fresh windstorm capacity. Overtime, Marsh claims, these new entrants have also begun to enter the liability arena: “Thus, it could be said that the post-Katrina hard market for first-party insurance has to some extent contributed to the softening of the liability market with lower prices, broader cover and insurers increasingly ready to increase sub-limits for specific risks such as product recall and professional indemnity. [...] This is the fifth soft year in a row for most types of liability insurance – countering the often received wisdom that insurance markets are subject to three-year cycles.” The Marsh report shows that the various niche markets are interrelated.

Volume

In terms of volume, the cycle appears to consist of periods of decrease and periods of stability, as Figure 2.2 shows. In the past few years, the number of insurance policies has been stable. Looking further back in time, we see that the number of policies decreased from just above 100,000 in 1993 to less than 70,000 in 1999. The decrease is especially high in the number of property insurances: the number of policies went from more than 50,000 in 1993 to 26,565 in 1999 and 16,344 in 2006. According to some of the interviewees this is partially due to an increased capacity of the provincial market. Another important reason for this decrease in number of property policies is the fact that – for efficiency reasons – small policies were either taken from the market or placed in commodity pools. In the casualty segment, there has been growth caused by new risks, like Directors & Officers liability insurance.

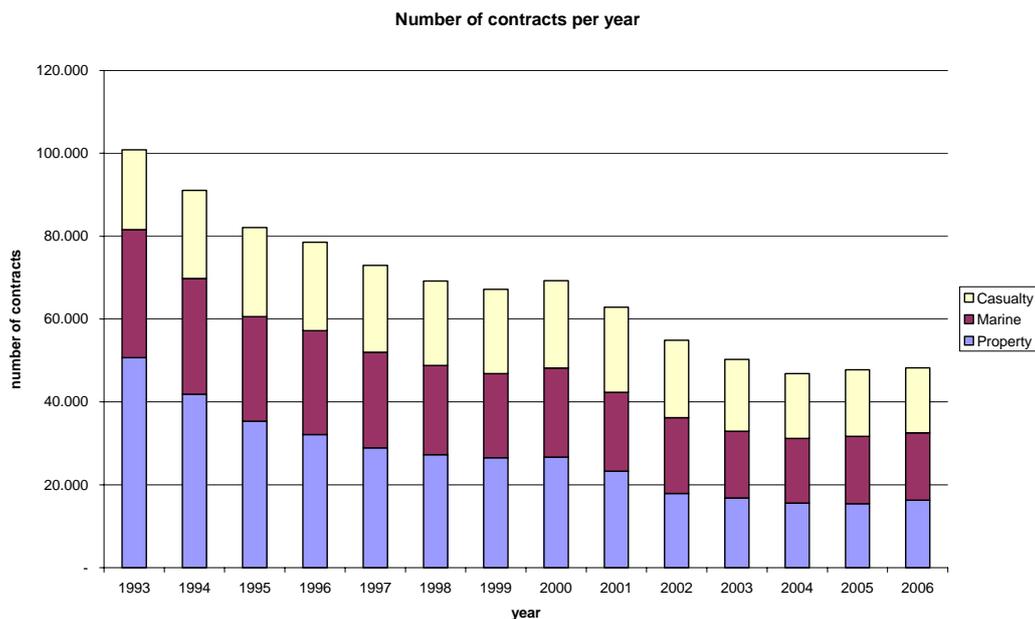
Premiums

The cycle in terms of total gross insurance premium (paid by customers) has a different shape (Figure 2.3). Remarkably, total premium is stable in times of a stable number of policies,²⁵ but increases in times when the number of policy decreases. It is unknown whether this is caused by the regular soft-hard-soft-cycle (insurance becoming more expensive), or by an increase of the insured volume. Note that premium data underestimate the total premium income from coinsurance, because coinsurance agreements are also entered into without going through the insurance exchange. In addition, some of the contracts entered into on the insurance exchange are not included in VNAB's figures because large internationally active insurers pay part of the premiums directly through foreign parents or subsidiaries.

²⁴ One of the respondents adds “and regulation on the Dutch market”.

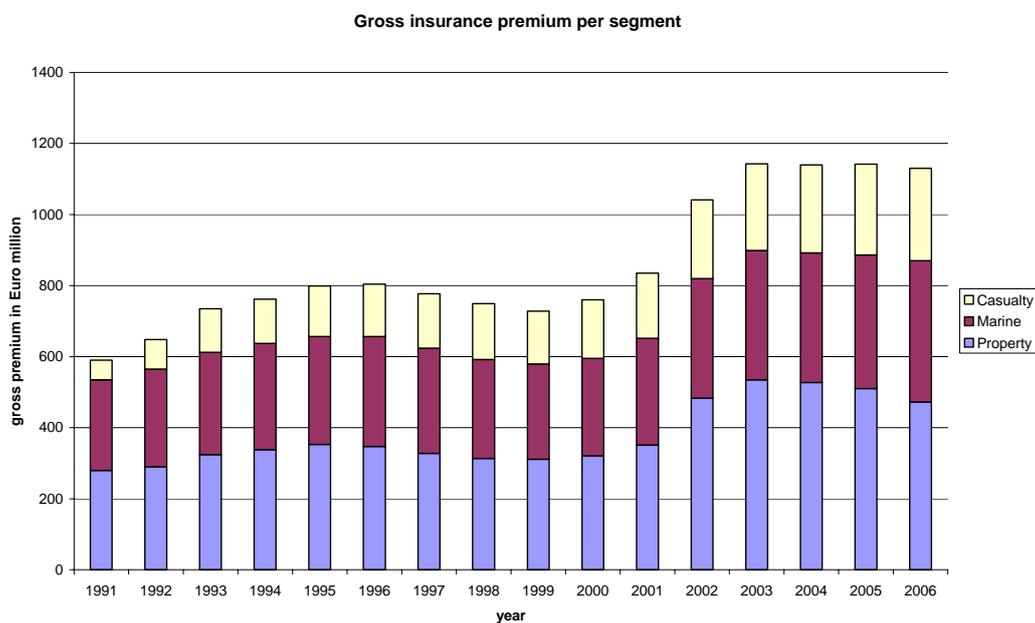
²⁵ Duration of policies is either one or three years.

Figure 2.2: Number of coinsurance policies (1993-2006)



Source: Annual reports of the VNAB, edited by SEO Economic Research

Figure 2.3: Gross premium per market segment (1991-2006)

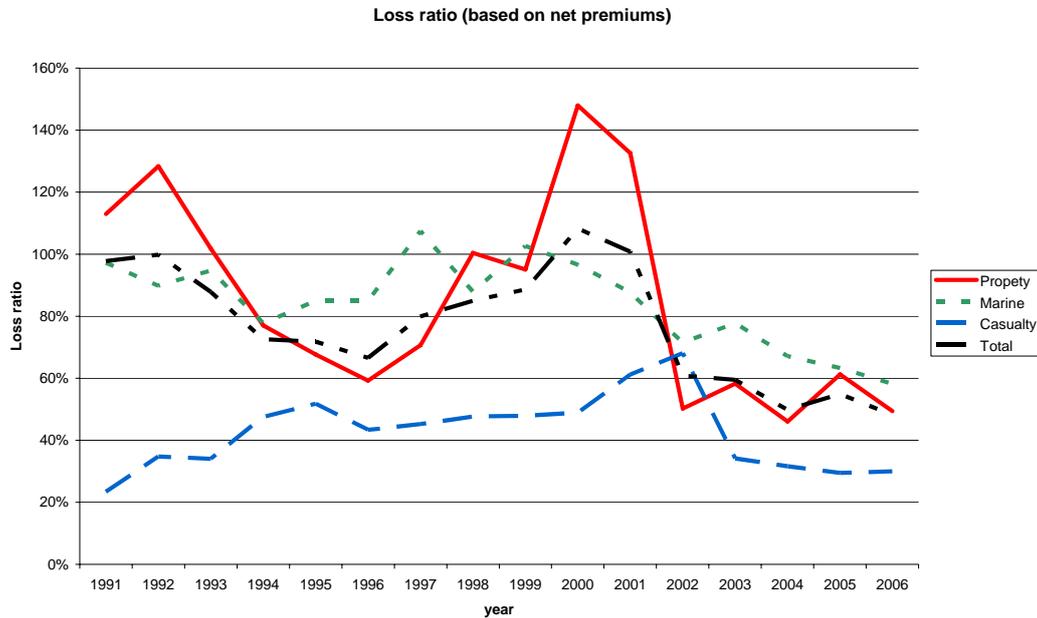


Source: Annual reports of the VNAB, edited by SEO Economic Research

The decline in gross insurance premium in the end of the nineties coincided with an increase in the loss ratio (based on net premiums) (Figure 2.4). This indicates a reduction in the profitability of the coinsurers' business. Please note that the loss ratio is constructed excluding the liability

claims directly paid to third parties and excluding incoming and outgoing premium and loss reserves.

Figure 2.4: Loss ratio (1991-2006)



Source: The annual reports of the VNAB, edited by SEO Economic Research

2.3.4 Position of the broker

Brokers mediate between the customer and insurers. To be active on the insurance exchange, a broker must be a member (of the brokers section) of VNAB. As is clear from the several interviews and confirmed by publications of London Economics and NMA, brokers are the key players in the value chain. They do nearly all the work: they structure transactions, and take care of all the paper work in closing the deal and in the aftermath: renewal, claims, and so on.

In addition to analysing the customer's wishes and negotiating with insurers, the tasks of the broker on the insurance exchange also include:

- Drawing up a risk analysis of the object of the insured, which is presented to the insurers;
- Drafting the insurance cover and possibly drawing up a draft of the policy text which will be presented to the insurers (the so-called cover note);
- Drawing up the coinsurance agreement;
- Collecting the premium. In the property and marine segments, the insurance brokers and not the insurers incur the risk that it will not be possible to collect the premium;
- Handling claims.

The position of the broker is discussed in more detail in chapter 3.

2.3.5 Position of the insurers

In order to be allowed to trade on the insurance exchange insurers must be members (of the insurers section) of VNAB.

Since the brokers structure and administrate the deals in the market, the role of the insurers is merely financial. They underwrite risks, by building up portfolios of policies. When potential leaders need to make quotations, they have to make their own risk assessment. Some leaders employ their own risk assessment professionals, others hire them project based in the market.²⁶ Risk assessment reports have a technical, not a commercial, nature.

Deals in the market for coinsurance exist of one leading insurer, and a group of followers (except for the so-called 100% market). When entering into an insurance agreement, there is always one lead insurer (the leader). The group of followers includes three kinds of carriers: would-be leaders that participated in the first stage, would-be leaders that did not participate in the first stage and ignorant followers. The latter followers generally take their decision on the basis of the fact that the lead insurer is willing to underwrite part of the risk. So the reputation of the leader is very important. In a soft market, due to an increased risk appetite more insurers do research themselves into the risks of the object to be insured and make an offer to the broker.

Leader

The leader is the first to sign and takes in general on the largest part of the risk. The lead insurer is often the insurer with most knowledge of a certain type of insurance. The lead insurer also takes the lead in settling claims. According to the 'to follow clause', which stipulates that when a claim is agreed and paid out by the leader, the leader must be followed and the followers must make a proportional contribution to the payment of the claim (NMa (2005)).

The number of potential leaders in a specific situation may be low. Leaders need both capacity and know-how. About ten insurers alternate with one another as leader.²⁷ Larger insurers will take both leader and follower positions. A small number of insurers (especially some of the American insurers who are active on the Dutch coinsurance market) want only to take the position as leader. The latter estimate that the loss from the extra risk of being a follower is larger than the reduced costs because it is not necessary to make an own risk assessment.

Although the ignorant followers may have a cost advantage (less information costs), being the leader brings advantages too:

- First choice of participation;
- A larger share (as a result of having the first choice) in the contract;
- Being in control of the deal;
- Being leader brings intensive contacts with the broker involved – these contact easily bring new deals.

²⁶ The existence of a market for risk assessment makes it easy for insurance companies to upgrade from follower to (potential) leader. The costs of a risk assessment report lie on average between 750 and 1.000 Euro.

²⁷ The number of potential leaders varies per sub-market.

Would-be leaders

If potential leaders participated in the negotiation stage, these would-be leaders have made their own assessment of the risk, and thus are aware of the technical details of the deal. The fact that they were not chosen as leader indicates that they have to improve their offer to be able to participate as a follower. These would-be leaders are not always invited to participate in the second stage because sometimes their offer was too much out of line with the accepted offer and the broker may consider it unlikely that these insurers will join as followers and therefore concentrate on bringing other insurers on board as followers.

The second set of potential followers includes other major insurers (generalists) with the skills and know-how necessary to assess the risk they are being invited to underwrite, but that were not invited in the first stage of quotation.

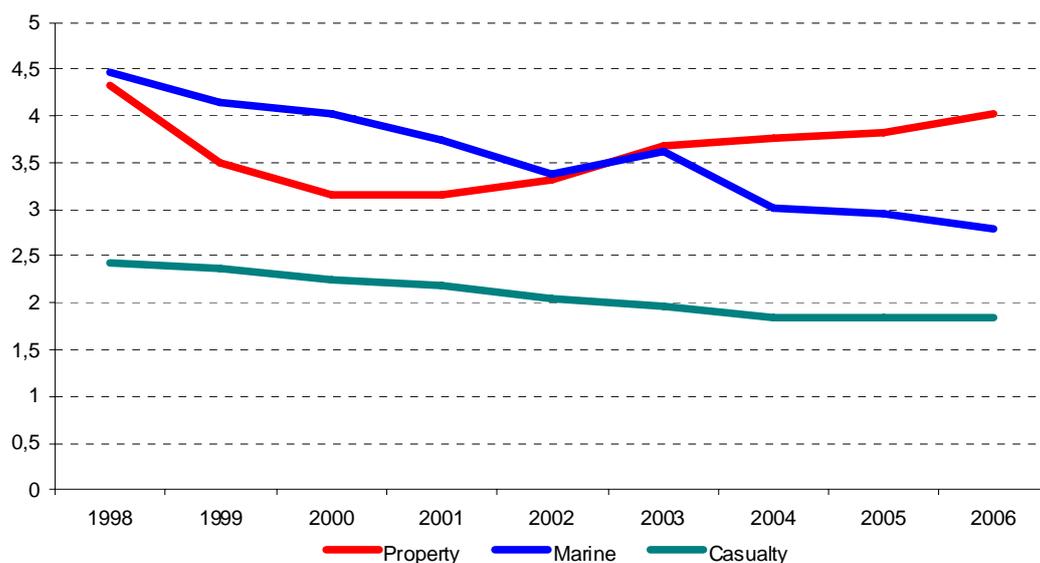
Other followers

Another group of insurers provides *innocent capacity*. The insurers don't have the wish, capacity or the knowledge to be leader. Ignorant followers have less in-house skills and experience and follow the leader because of its known capabilities and its reputation as a leader (London Economics (2006)). Because of this they are usually not able to offer lower prices than the leaders. Although they make fewer costs because they simply buy into the risk without undertaking the same amount of due diligence as the (would-be) leader(s), their risk is higher because they have to rely on second hand information. Uncertainty about the abilities of the leader is an additional risk for these followers.

The EC suggests that a second tender to select the followers is a way to overcome possible problems with alignment of premiums and conditions. First, it is not clear that the current practice of premium alignment is anti-competitive. Also, a second tendering entails (high) costs that will have to be paid by the customer. Moreover, the share of the ignorant followers per policy is usually small. The effects of premium alignment are, therefore, if any, not too large. This is especially true if the Dutch coinsurance market is compared to the UK market. In the UK the share of the innocent capacity per policy is estimated to be higher because more insurers share the same risk. Finally, many of these followers are lacking the skills and experience to price the risk on their own if there were restrictions on sharing information about the leader's price. This would probably withdraw followers' capacity from the market, which will – in hard markets – lead to lack of capacity and/or upward pressure on premiums.

Number of followers

The average number of insurers per transaction is three: one leader and two followers. Figure 2.5 shows the average number of insurers (leader and followers) per contract per annum and per segment. The numbers of broker per contract is 1, by definition. In 2006, property policies on average are covered by four insurers (one leader, three followers), marine policies by 2.8 insurers, and 'other' policies by two insurers: one leader and one follower (or co-leader).

Figure 2.5: Average number of insurers per policy

Source: The annual reports of the VNAB, edited by SEO Economic Research

As stated above, a fair share of the coinsurance market is entirely underwritten by a single insurer, the leader (in 2006 on estimation half of the number of contracts, representing 25% of the premium value). This 100% segment is the largest (in terms of volume) in the casualty segment, and the smallest in the property branch (cf., Table 2.3).

Table 2.3: The 100%-segment (2006)

Sector	Percentage 100% contracts
Property	32%
Marine	51%
Casualty	69%
Total	50%

Source: The annual reports of the VNAB (edited by SEO Economic Research) and information from the interviews

In order to focus on the risks that are really *coinsured*, we exclude the 100% market from Figure 2.5 (we only have the 2006 data on the 100% market). Table 2.4 shows that the number of insurers per policy increases to 4.90 (implying that the average share of the risk is 20.4%), varying between 5.46 (property) and 3.71 (casualty).

Table 2.4: Average number of insurers per transaction (2006)

Sector	Including the 100% segment	Excluding the 100% segment
Property	4.02	5.46
Marine	2.80	4.69
Casualty	1.84	3.71
Total	2.94	4.90

Source: The annual reports of the VNAB (edited by SEO Economic Research) and information from the interviews

2.4 Institutional context: (self) regulation

2.4.1 Position of the VNAB

Being a member of the VNAB (the Dutch Insurance Exchange Association) is not obligatory, but very common. The total share in the number of BCS transactions of insurers outside the VNAB and of foreign insurers participating in a Dutch coinsurance policy adds to 7%. It is therefore important that the membership conditions are transparent and objective.

The role of the VNAB on the coinsurance market is primarily facilitating. The shared clearing system and claim handling system are strongholds for the Dutch coinsurance industry. Besides this the VNAB designs standards for insurance exchange policies (in co-operation with the Dutch Association of Insurers). These standard insurance exchange policies give a description of the occurrences which are covered (i.e., property, water and storm damage) and contain clauses in relation to the period of notice and claims settlement (i.e., the appointment of experts). As NMa (2005) states: “The standard insurance exchange policies [...] make it possible to take out insurance quickly and efficiently because the insurance broker would otherwise have to negotiate every clause with all the insurers involved. This would increase the transaction costs considerably.” Usually the insurance brokers draw up their own policies that are based on the standard policies and clauses with their own modifications. Through these modifications the better broker can distinguish himself from other brokers. In addition to the standard insurance exchange policies, insurance brokers also draw up their own policies.

Also, the board of the VNAB aims at increasing awareness of competition regulation in order to further improve compliance with this regulation.

2.4.2 Position of the Dutch and EU regulators

In the interviews it is indicated that the role of the Dutch and European Union regulators is not an issue from the perspective of the competition issues raised in the final report of the EC (2007) (Authority for the Financial Markets – AFM; De Nederlandsche Bank – DNB, the Ministry of Finance; and the EC). Requirements for players in the coinsurance market are the same as those in the provincial market (cf., section 2.3.1). It is noted that the European Service Directive offers foreign providers the possibility to work under their home license in the Dutch market.

For insurance the EU has as a main objective which is the creation of a single market. Because this requires a common framework to allow insurers to operate throughout the EU and to establish and provide services freely, the goal of the EU is harmonisation (next to protection of customers). To achieve this goal, the EU has adopted several directives, which have laid down the conditions to conduct insurance business in the internal market.²⁸ This is achieved by a common prudential framework, founded on three generations of life and non-life directives, harmonising essential rules. Insurance directives have set up a supervisory regime of single license and exclusive prudential supervision by the competent authorities of the insurance undertaking's

²⁸ For an overview of EU regulation on non-life insurance see: http://ec.europa.eu/internal_market/insurance/legis-inforce_en.htm#nonlife.

Member State. This supervisory regime allows the insurance undertaking to conduct business in any other Member State, under the freedom of establishment or the freedom to provide services.

For the coinsurance market, Regulation 358/2003 is important, as it block-exempts the following types of agreements in the insurance sector²⁹: (1) the joint establishment and distribution of calculations and studies; (2) the joint establishment and distribution of standard policy conditions; (3) the joint coverage of risks³⁰; and (4) the establishment, recognition and distribution of technical specifications, rules and codes of practice on security devices. Agreements under (3) are essential to the coinsurance market.

The EU regulation also affects the brokers. The Insurance Mediation Directive (IMD), which became effective in 2005, is intended to create a single market in insurance via a ‘passport’ for EU retail insurance intermediaries. In return for the passport Member States are required to set certain minimum standards for taking up and continuation of the business of insurance mediation. The IMD provides that brokers, on the basis of their registration in their home country, can do business in other EU Member States (London Economics (2006)).

Although this EU regulation aims at increasing cross-border competition between insurers and between brokers, the Dutch market is relatively national, that is, most contracts are made between national customers and suppliers who are active in the Dutch market (cf. chapter 4).

2.5 Summarising: How deals are made³¹

All transactions are done via brokers.³² A customer who has complex and/or large risks asks several brokers how much it would cost in order to have this risk insured, including the services of the broker himself. For a broker to be asked by a customer it is very important to know the customer in person. That is why it is often said that the coinsurance business is a peoples’ business. Of course, it is equally important that the customer is convinced that the broker is good in what he does, that is, structure the risk financing solution and have a good picture of the supply in the market.

After a client has stated a request for insurance, the broker takes over. He assesses the risk involved, and designs an insurance product, in agreement with the client either with or without an initial price (in a soft market, it is often the broker who takes the initiative and invites the

²⁹ Commission Regulation (EC) 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, Article 1.

³⁰ The literal text of the article: “The setting-up and operation of groups of insurance undertakings or of insurance undertakings and reinsurance undertakings for the common coverage of a specific category of risks in the form of co-insurance or co-reinsurance”.

³¹ This section draws on information from the interviews and London Economics (2006).

³² The insurance agreement can be entered into directly by a broker with the various insurers, but may also be underwritten by an authorised agent (i.e., someone who receives a power of attorney from an insurer to accept risks up to a certain maximum amount). To trade on the insurance exchange, an authorised agent must be a member of the insurers section of VNAB. Previously, authorised agents had a very strong position on the insurance exchange. The number of authorised agents active on the insurance exchange has decreased in recent years due to acquisitions by insurers. Currently, the VNAB has 8 authorised agents as a member.

insurer to react to his first (deliberately low) indication of the price; in a hard market this is usually done by the insurer). The broker will run either a formal (private tender) or an informal (broker calls insurers) competition for the coverage of the risk by a lead insurer. To that end, the broker makes up a short list of mostly 2 to 4 insurers that could be the leader, and he asks these insurers for a quotation. The long list, that is the list of insurers who could in principle cover the risk, consists of both generalists and specialists. Around 15 generalists – that is, large insurers who are able to cover all kinds of risks – are active on the Dutch market. For insurers to be asked for a quotation it is again important that the insurer knows the brokers that are in the market. Personal networks are, therefore, very important in the coinsurance market.

Potential leaders give their own bid price in reaction to the broker's first (deliberately low) indication of the price, or based on their own assessment of the risk and claim experience. Based on his experience and market knowledge, the broker judges which insurer has the best papers to supply the financial capacity and the skills and know-how to underwrite the risks. It is also possible that the broker advises that the risk is best placed with a single insurer instead of with multiple insurers. In the latter case, the broker also asks 2 to 4 insurers for a quotation.

The actual quotations received from the insurers will likely vary in terms of price, deductible, conditions (scope of coverage, layering and so on), and share of the risk that the insurer is willing to cover as leader. Subsequently, a period of negotiation starts between the broker and the potential leaders, until the best package for the client is achieved. The negotiation process already starts before the broker receives the first quotation. He then uses this quotation to extract the best package for his client from other insurers. The broker may ask one or several insurers, who had provided a quotation to the initial call for quotes, to revise their quotations in the light of the responses from competitors, typically to revise down the price and/or improve their conditions.

Leaders are mainly chosen on terms of the price (premium) offered. However, the best offer may not necessarily be the cheapest one as it is the overall quality of the offer that matters. As to insurers, the larger brokers apply their own rating systems which are frequently adjusted. Quality of the insurer (e.g., credit rating) is the dominant criterion, followed by insurers' knowledge of the risk involved. Because of their central position, the brokers claim to have insight in matters whether the risk will fit into the portfolio of insurers, and thus whether they will be interested in the first place. The broker and the insurer then settle an agreement on price (premium) and conditions. If the offer accepted does not fully cover the risk, the broker will advise, based on his knowledge of the market place and experience, a client how best to fill the gap and informs the client which other insurers will be approached to fill the gap.

After the leader is selected, the second stage starts. The broker fills the remaining capacity with followers. These insurers can be the same as approached in the first phase, but this is not self-evident. Followers have access to the assessment made by the leader and in some cases their own assessment which was made in the first stage and the price set by the leader. Mostly, these followers do not compensate the leader for this information. In essence, the current market practice is for the broker to present the contract agreed between the customer and the leader to the followers, and for the followers to either accept or decline to take a share of the risk on the same terms and conditions (including price) as the leader. The followers can take a share of the risk at the price of the leader or indicate that they are only willing to accept the conditions for a higher price. The latter merely occurs in a hard market.

This mechanism guarantees price competition among insurers (internal competition). On top of that, there is an exogenous cap on coinsurance process: customers can often turn to others insurance companies active outside the coinsurance market (in combination with reinsurance). This external competition increases the competition on the coinsurance market.

Another advantage of the mechanism of alignment of premium and conditions after the leader is selected, is that this mechanism results in an efficient and faster completion of the full coverage of the risk as followers simply have to accept (or reject) the proposed terms and conditions.

Sometimes, in a really hard market it appears impossible for the broker to have a contract fully underwritten. In that case the broker has to advise the client on the best way to handle the gap. The client can choose to accept a higher price and/or a limitation in the conditions or coverage (and/or has to accept that the risk remains partly uninsured). The occurrence of followers asking a higher price does not affect the price of the leader. This used to be different when the best term and conditions (BTC) clause was still in use: if the leader had agreed on BTC in earlier days he would have been able to insist on the higher price the follower had stipulated.

Finally, an insurance contract is made in which the total risk is split among insurers. They can have their own price, but they generally offer insurance under the same conditions. Deviations do occur, but only occasionally.³³ As is indicated during the interviews the players in the market object to deals with different conditions for different insurers. Such a situation would lower efficiency: an unclear contract for the insured business (e.g., how do these different conditions compare if a claim were lodged), high transaction costs for the broker (ending up in the premium) and problems in the case of claims handling.

The dependency of the followers on the risk assessment of the leader really makes reliability of the leader a key issue. This provides the market with a strong incentive for transparency.

Duration of policies & switching costs

Normally contracts last for 12 or 36 months, with silent renewal. This is not in line with the view of the European Commission (EC 2007). Contracts that are due to expire are evaluated. The broker searches the market for a better deal and will switch if this is beneficial to the client or will prolong the present contract if no better deal is available. If no better deal is available the average period of insurance contracts lasts longer (about five years). Switching costs for the client are generally considered to be low. This means that clients generally are not faced with a lock-in situation. In the words of NMa (2005): “Coinsurance agreements are generally entered into for a short period (one year). As a result, policyholders can switch fairly easily.”

This fact also questions the remarks that the European Commission makes about the renewal of contract in the Netherlands in the final report and in the interim report (both published in 2007).³⁴ However, in the final report the EC recognises that the problems raised earlier with respect to contract duration in the Netherlands are indeed resolved (Memo EC (2007a)).³⁵

³³ Usually because foreign insurers want to add special clauses in order to comply with regulations in their home country.

³⁴ On p. 79 the EC report says: “The findings of the Interim Report show that, as far as contracts for SMEs are concerned, in a majority of Member States, the average duration of contracts is approximately or a little over 12 months. However, in a few Member States (Austria, Slovenia, Italy and the Netherlands), the average duration was found to be much higher: in Austria it was calculated as approximately eight years (101 months),

2.6 Efficiency of the Dutch coinsurance market

The Dutch coinsurance market is said to be very efficient compared to for instance other national markets. This is also shown in a report of Marsh (2007). Marsh surveyed 2,822 European companies about their product and general liability insurance programmes, including data on limits purchased and premiums. Liability is a typical coinsurance product. The Marsh report gives the average premium (i.e., price per million Euro covered). The Netherlands has the lowest premium after the UK (7,944 and 6,762 Euro, respectively). The efficiency of both markets has to do with the central role of the broker on these national markets (cf., chapter 3). Other European markets have much higher premiums, for instance Belgium (11,214 Euro), Germany (12,409 Euro), and France (16,537 Euro). This result supports the hypothesis that the Dutch market is relatively efficient.

Another way to prove the efficiency of the Dutch coinsurance market would be to compare the premiums and costs between the coinsurance and provincial market. However, such a comparison is a bit like comparing apples and oranges because these markets are quite different. A coinsurance policy is essentially different from a provincial policy, because the risks involved differ as for the scope and complexity. Consequently, the distribution of coinsurance policies and provincial policies differ. As stated before, the tasks of the broker on the coinsurance market are more extensive than those of a broker who mediates on the provincial market between the customer and the insurer. The main difference is that in the provincial market the insurers structure the contracts, whereas in coinsurance market the brokers structure the contract. Given the size of contracts, coinsurance competes rather with the combination of provincial insurance and reinsurance, than with provincial insurance alone.

Having said that, it is still instructive to compare the premiums and costs between these two markets. This comparison is possible because there are some insurers who offer both coinsurance and provincial policies. Based on the interviews and the data we received, we know that the brokers' fee plus the insurers' costs add up to somewhat more than 40% of the total gross premium income on the provincial market against less than 25% on the coinsurance market. This is a significant difference in costs between both markets, implying that for large risks coinsurance is more efficient than provincial insurance. This advantage is due to:

- Specialisation of the players in this particular market;
- The broker has purchasing power and is therefore better able to play insurers off against one another;
- The central role of the broker that stimulates competition among insurers;

in Slovenia almost seven years (81 months), in Italy approximately six years (73 months), and in the Netherlands, approximately six years (79 months).” [SME stands for Small and Medium-Sized Enterprise].

³⁵ Later, on p. 81, the EC gives a description of the Dutch situation that fits the coinsurance market better than the description on p. 79: “Dutch industry respondents consider that the Dutch insurance industry is moving towards shorter terms (1-3 year terms) in the SME segment. It seems that annual contracts have long been standard practice in the Netherlands within the LCC segment (since 1990). The Commission services do not have evidence that long term agreements have presented a barrier to entry for insurers wishing to enter the Dutch market.” [LCC stands for Large Corporate Clients].

On p. 87, where the EC gives its conclusions, the Netherlands is no longer mentioned as one of the countries with long duration of business insurance contracts.

- The existence of the shared clearing house and claim handling system;
- The possibility of diversification in the portfolios of insurers;
- The existence of (commodity) pools;
- The high costs of reinsurance.

NMa (2005) also reports that the coinsurance market is cheaper than the provincial market: “These rates [the coinsurance brokers’ rates, SEO] are lower than the commission on the provincial markets.”

For small risks, the provincial market is considered to be more efficient. For the 100% segment of the coinsurance market, in which a single insurer underwrites risks, the coinsurance market is said to be more efficient, because the contracts need special knowledge, derived from the mainstream coinsurance market. Here the broker plays an important role. It would be interesting to compare the performance of policies originated from the provincial channel with the 100% segment of the coinsurance market. However, the data needed for such a comparison are not available.

2.7 Conclusions

In this chapter we conclude that:

The coinsurance sector is commonly divided in three segments: brand (property), transport (marine) and varia (casualty), with market shares in the coinsurance market in 2006 of 42.6%, 32.6% and 24.8%, respectively. The market share of the coinsurance market in the total business insurance market is 38.3%.

The coinsurance market can be divided into two different segments: (1) multinationals and (2) medium-sized firms. For the second segment, having a risk underwritten by a single insurer on the provincial market may be an alternative to the coinsurance market. In that case brokers will examine possibilities for their customers both on the provincial market and on the coinsurance market (i.e., 100% market).

The number of brokers has been stable during the past decade, whereas the number of insurers is decreasing, especially since 2003. Some dynamics – entry and exit as well as mergers – in the number of players exists. Except for legal requirements, the most important barriers to entry are membership of the VNAB (which is needed to have access to the BCS (the central clearing system) of the E-Abs) and knowledge of the Dutch language and market. However, these barriers are not high in the sense that they prevent successful entry in the market. NMa (2005) also notes that the requirements for admission to the insurance exchange are not strict and that the admission procedures do not take long. NMa concludes that: “Both insurers and insurance brokers could easily enter or exit the insurance exchange.”

Continued on next page

Although, both the insurer's market and the broker's market are moderately concentrated according to the Herfindahl Hirschman Index (HHI), which is a commonly accepted measure of market concentration, this does not have to raise competition problems. For instance, the fact individual brokers within the firms have important roles, significantly softens the impact of market concentration. Moreover, HHI will be lower if we take into consideration that a number of the provincial intermediaries sometimes act as producers and as such 'hire' coinsurance brokers – who then act as so-called wholesale brokers – to do their deals. Similarly, the impact of market concentration in the insurance market is softened by the fact that that (big) leaders need (smaller) followers to close a deal. Moreover, niche players are active on the insurance exchange, which do not offer all products, but focus on certain types of insurance for which they are strong competition for the big all-round insurers. Third, for medium-sized companies, the provincial non-life market is an alternative to coinsurance; and for the largest firms London and other international markets are an alternative.

The average number of insurers per transaction is three: one leader and two followers. The numbers of broker per contract is 1, by definition. In 2006, property policies on average are covered by four insurers (one leader, three followers), marine policies by 2.8 insurers, and 'other' policies by two insurers: one leader and one follower (or co-leader). In order to focus on the risks that are really *co*insured, we should exclude the 100% market from these figures. The average number of underwriters then is 4.9 insurers (implying that the average share of the risk is 20.4%), varying between 5.46 (property) and 3.71 (casualty).

The current practice of premium alignment is not anti-competitive. The broker presents the contract (including the same terms and conditions) agreed between the customer and the leader to the followers. The latter can either accept or decline this offer or he can settle for a lower price or less favourable conditions. This mechanism guarantees price competition among insurers (internal competition). Moreover there is external competition from others insurance companies active outside the coinsurance market (in combination with reinsurance). Another advantage of the mechanism of alignment of premium and conditions after the leader is selected, is that this mechanism results in an efficient and faster completion of the full coverage of the risk as followers simply have to accept (or reject) the proposed terms and conditions.

Although the European Commission seems to suggest otherwise, normally a coinsurance contract lasts for 12 or 36 months (with silent renewal). With the NMa (2005), we conclude that policyholders can switch fairly easily.

The Dutch coinsurance market is efficient compared to other national markets and to the provincial market. For instance, the Netherlands has the lowest average premium for liability policies premium after the UK. The efficiency of both markets has to do with the central role of the broker on these national markets. Other European markets have much higher premiums.

A comparison of coinsurance and provincial policies shows that the brokers' fee plus the insurers' costs add up to somewhat more than 40% of the total gross premium income on the provincial market against less than 25% on the coinsurance market. This is a significant difference in costs between both markets, implying that for large risks coinsurance is more efficient than provincial insurance. Important efficiency enhancing mechanisms are (commodity) pools and the shared clearing system and claim handling system.

3 The central position of the broker

In this chapter we give further details on the importance of the position of the broker (section 3.1). We address, among others, the question of conflict of interest (section 3.2) and (in)transparency of remuneration (section 3.3).

3.1 The broker facilitates competition among insurers

Brokers play a key role, as they help clients identify the risks they face. Also, they help clients in understanding and coping with the complexities of the insurance marketplace and reduce the clients' search costs by helping them to find the most appropriate insurance policy. This means that brokers overcome the information asymmetry faced by clients. Brokers can have this function in the market because they are constantly in the marketplace and aware of the latest developments in terms of capacity, pricing, and quality of insurers. Brokers can thus help clients to obtain the best insurance deal. The superior information brokers bring to the marketplace is a major driver of competition between insurers and helps overcome the clients' search costs, which is a major inhibitor of switching. By lowering these search costs and making the market more transparent, brokers make it easier for their customers to switch from one insurer to another. Moreover, brokers may help clients to obtain better terms on their policies due to the higher business volume they bring to insurance companies. To explain further the critical role played by brokers in minimising the costs of insurance for their customers it is instructive to once again look at the process of picking followers from would-be leaders. When the insurers that were unsuccessful with their bid to be leader are asked as a follower, the premium alignment to the accepted offer from the leader results in a reduction of their premiums relative to the premiums they had originally quoted.³⁶ In many cases, especially in hard markets, achieving such a result requires considerable negotiations and persuasion from the broker.

Brokers also have a function for insurers as they help insurance companies overcome their imperfect knowledge of the precise risk profile of each potential client. For insurers, the existence of brokers as a distribution channel allows them to extend their geographical and client reach without having to incur the fixed costs of a fully-fledged distribution network. The wider reach of each insurer increases the competition in the business insurance marketplace as it increases the choice of suppliers for clients. London Economics (2006) concludes that this in itself increases the intensity of competition in the business insurance sector.

The interviewees indicate that brokers act as senior staff in the sense that each of them has freedom to act within brokers' firms: each of them maintains his own personal network of clients and insurers. His personal network appears to be equally important to his firm affiliation. Since most brokers' firms employ more than one broker, the personal network of each broker makes the risk of fixed patterns in tendering low. That is, brokers' firms deal with different insurance

³⁶ To put it differently: the broker will bring in as followers some of the unsuccessful bidders at a premium below the price they had indicated in their bid for leader.

companies in different tenders (no fixed combinations). The personal networks within the (medium-sized and larger) brokers' firm add up to the entire population of insurance companies.³⁷ However, the importance of personal relations is decreasing, partly because of a tighter policy from the management of the brokers' firms, partly because the introduction of the E-Abs (electronic insurance exchange system) replaced the physical exchanges in Amsterdam and Rotterdam.

Note that on the Dutch coinsurance market, we have two times as many brokers as insurance companies (cf., Table 2.1). A broker negotiates with on average 5 to 15 insurers (leaders as well as followers) before closing a deal with some of them. From Table 2.4 we know that the average number of underwriters is high: almost five insurers are involved per transaction on the coinsurance market. Given the fact that the composition of the insurers involved in a contract varies all the time, the broker has an important role in increasing competition among insurers. So, the relatively high proportion of brokers together with the fact that fixed combinations do not occur implies that the distribution via brokers guarantees that insurers have to compete intensely.

Competition between brokers is tough, and the market for their services is transparent. Relations between customers and brokers are long lasting. If a large customer decides to switch to another broker, this leads to serious reputation damage to the broker in question.

3.2 Conflicts on interest

We have no reason to assume that conflicts of interest occur in the market under study. Brokers in the Dutch coinsurance market work – except for the administrative handling of policies and claims – solely on behalf of the customers (Van der Wal (2007)). Brokers work for the customer in the insurance process and act on behalf of the customer (similar to the lawyer-client relation).

Conflicts of interest nearly never arise on the Dutch coinsurance market as the broker is not constrained by agreement to refer business to one particular insurer. As recognised by the Commission, brokers may in that case be able to stimulate competition in the insurance marketplace.³⁸ Since brokers work on behalf of and in the interest of the client, they have a strong incentive to make sharp deals.

Moreover, conflicts of interest do seldom occur because the market is transparent. If a broker delivers services to an insurer, the insurer of course pays (directly or indirectly) for these services. This is not problematic from a competition point of view as long as this remuneration is transparent. Often the broker actively provides the client with information on the costs covered by insurers. In other cases the client asks the broker which part of the premium consists of costs covered by the insurer (passive disclosure of information). Sometimes, mostly this concerns the

³⁷ Unfortunately, we do not have statistics on the number of brokers per firm.

³⁸ On p. 49 the EC states: "Through their activities, which allow access to a wider choice of potential insurers (including the international insurance markets for the placements of larger or specialty risks) and which reduce asymmetries in bargaining power of the parties, intermediaries that are not constrained by agreement to refer business to one insurer, especially insurance brokers, may be able to stimulate competition in the insurance marketplace."

smaller clients, the client is not interested in – and therefore does not ask for – information on the premium and costs. These clients are purely interested in the total gross premium.

Insurers underwrite policies at comparable terms and do not directly deal with customers. That may be a circumstance not enhancing competition. However, the role of the brokers, given that there are enough of them in the market, provides competitive incentives for the insurers. Therefore, the competitive fringe (many small brokers who discipline the four or three large ones) is essential. We conclude that as long as the broker market is competitive no competition issues exist.³⁹

3.3 Remuneration

There are several ways brokers are compensated for their efforts. Traditionally, insurance brokers are paid through a commission, a percentage included in the premium. The reward of the brokers is commonly negotiated with the customer. That is, the customer and the broker agree on the broker's reward.⁴⁰ Provisions are about the same among different insurers; there is no such thing as competition on provision. This is also stated in the research done by NMa (2005): "According to the interviewees, most of the contracts provide for commission paid to the broker by the insurers. The respondents stated that a broker, in principle, receives the same commission rate from all insurers."

Fees/Premiums

Commissions are dominant in the business-to-consumer market. In the business-to-business market, there is a long history of fee-based reward schedules. Most brokers who work for large customers work on a fee basis, whereby all the services for the customer are specified and invoiced. In these cases, the commission is credited to the customer. For a long time, a shift has been observed towards working on a fee basis. The interviewees also stated that this method of remuneration is increasingly used.

Although commission is a way of compensation that is accepted by all parties (including customers), they carry an inverted incentive: if the broker is paid with commissions, and he achieves a reduction of X% of the premium, his income declines with X% as well. That may lead too (perceived) conflicts of interest. That explains why a fee system, which has always been around for one or two decades, has been winning ground lately. The insurer receives a net premium, and the payment of the broker is directly settled between client and broker.⁴¹ The use of a fee remuneration system of fee schedule started with large customers, but nowadays more and also smaller firms compensate brokers on a fee basis.

³⁹ Although a lot of little brokers does not change the concentration ration C3 in the market, it does change the HHI indicating the lower concentration of the market.

⁴⁰ Brokers differ in their level of transparency on their rewards. Some even quote it on their websites, others are more secretive.

⁴¹ The insurer doesn't have information on the amount paid.

Table 4.1: Total commission earned by brokers (2000-2006)

Year	Gross premium brokers (€G mln)	Net premium brokers (€N mln)	Difference (€G - €N)	In % of gross premium income earned by brokers
2000	760	641	119	15.7
2001	835	709	126	15.1
2002	1,041	894	147	14.1
2003	1,143	987	156	13.6
2004	1,140	983	157	13.8
2005	1,142	985	157	13.7
2006	1,130	975	155	13.7

Source: The annual reports of the VNAB (edited by SEO Economic Research) and information from the interviews

Table 4.1 gives a general idea of the total commissions earned by the brokers on the coinsurance market in the period 2000-2006. In 2006, brokers who were members of VNAB recorded 1,130 million Euro on gross premiums and 975 million Euro on net premiums. The difference, 155 million Euro, is the commission that the brokers receive from the insurers. This amounts to a remuneration percentage of 13.7%. Table 4.1 shows that this percentage has been around 13.7% for the last four years and was somewhat higher in 2000-2002.

The role of bonuses (contingent fees)

Bonuses (extra rewards paid by insurers when brokers bring on more premiums) or contingent fees (additional remuneration paid by the insurer to the broker that is contingent on the achievement of agreed targets relating to the business placed by the broker with that insurer) deserve attention from a regulatory point of view. Bonuses may lead to miss-selling: the incentive for the broker to find the best deal for his client is overruled by an incentive to place risk with certain insurers.⁴²

Bonus schemes and contingent fees appear to be of minor interest in the coinsurance market, and they are in decline. Two insurers among the respondents estimate bonuses to be about 0.5 percent of total premium. The international background of the players is a helpful factor: the three largest brokers are American subsidiaries, which after the *Spitzer Report* (2004) no longer accept contingent fees.

3.4 Conclusions

In this chapter we conclude that:

Brokers play a key role in promoting competition in the coinsurance market as they bring superior information to the marketplace and help overcome the clients' search costs. By lowering these search costs and making the market more transparent, brokers make it easier for their customers to switch from one insurer to another. Moreover, brokers may help clients to obtain better terms on their policies due to the higher business volume they bring to insurance companies.

Continued on next page

Brokers also have a function for insurers as they help insurance companies to overcome their imperfect knowledge of the precise risk profile of each potential client. For insurers, the existence of brokers as a distribution channel widens the reach of each insurer, which increases the competition in the business insurance marketplace as it increases the choice of suppliers for clients.

The relatively high proportion of brokers compares to insurers together with the fact that fixed combinations do not occur implies that the distribution via brokers guarantees that insurers have to compete intensely.

Competition among brokers is described as being 'very tough'. Since they work on behalf of and in the interest of the client, they have an incentive to make sharp deals. Conflicts of interest nearly never arise because brokers are not constrained by agreement to refer to one particular insurer and because bonuses and contingent fees play a minor and decreasing role in the Dutch coinsurance market. Moreover, conflicts of interest do seldom occur because the market is transparent.

Insurers underwrite policies at comparable terms and do not directly deal with customers. That may be a circumstance not enhancing competition. However, the role of the brokers, given that there are enough of them in the market, provides competitive incentives for the insurers. Therefore, the competitive fringe (many small brokers who discipline the four or three large ones) is essential. We conclude that as long as the broker market is competitive no competition issues exist. In that respect, it is reassuring that the number of brokers has been stable during the last decade (cf. Figure 2.1).

⁴² Bonuses in the coinsurance market used to depend on insurer's profits, not on sales. A reward was paid as a percentage of profits, thus disconnecting production from the reward in the first place.

4 A national market

This chapter addresses question of a separate Dutch coinsurance market (section 4.1). Section 4.2 shows how the view on the coinsurance market of the Dutch Competition Authority differs from the view of the European Commission.

4.1 A separate national market

In the interviews it is discussed that the Dutch and London (Lloyds) market are much alike. What makes these markets unique is the role of the broker. In most countries the broker arranges the deal, while the insurers take care of structuring the policy. In the UK and in the Netherlands, the broker takes care of the entire deal (from the first risk assessment to the selection of insurers and drawing up and administrating the contract), while insurers merely finance the risk. The result depicted in section 2.6, that the UK and Dutch premiums are much lower than the premiums in other Member States, supports this conjecture about the UK and Dutch market. Besides the resemblance due to the central position of the broker, the Dutch and UK market differ remarkably. For instance, the scale of the UK market by far outreaches the Dutch market. The risks traded and the amounts involved are, consequently, very different.

As indicated in section 2.3.1 the national scope of the market is determined by the need for a physical presence and know-how of the national market. Although nearly all of the insurers as well as the largest brokers, have an international background, coinsurance should be considered as a mainly domestic market. This is also recognised in the report of the EC (2007).⁴³

Unfortunately we have been unable to find data on cross-border trade in coinsurance policies. If these data would be available, it would be possible to perform the Elzinga-Hogarty test. This test is used in competition cases to delineate the scope of the geographic market. The test specifies the LIFO and LOFI threshold. LIFO stands for little in from outside and asks whether imports into the region are small relative to total sales in that region. If import is more than 10% of the consumption in the region, the market is said to be broader than the region considered. LOFI stands for little out from inside and asks whether exports from the region are small relative to the total production in that region. If export is more than 10% of the production in the region, the market is again said to be wider than the region under consideration. As said, due to lack of data we cannot formally perform the Elzinga-Hogarty test.

From the interviews, however, we know that most Dutch coinsurance products are sold to Dutch firms. Also foreign risks are insured in the Netherlands. Marine insurance is said to be a very international business. Usually the sister companies of brokers who are active in the Dutch

⁴³ On p. 2, the EC states: "Primary insurance markets for most risks 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 similarly arise under national law which may substantially vary from one jurisdiction to another. In addition, there is a need for a local presence, often for distribution and always for claims settlement, and language issues may arise."

market place foreign based risks in the Dutch market. Still, the estimates of the share of foreign risks contracted by Dutch insurers comes down to one or two percent. This may be interpreted as a measure of the imports. This indicates that the LIFO criterion is met and the relevant geographic market is national (i.e., the Netherlands).

Between five and ten percent of the risks of Dutch customers is placed overseas, e.g., in London. This 'export' concerns the very large and complex cases, demanding a market with a larger capacity than the Netherlands can provide (i.e., the risks of companies like Ahold, Philips and Shell). This figure of five to ten percent indicates that the LOFI criterion is met and the relevant geographic market is national (i.e., the Netherlands).

Based on these figures from the interviews as well as the description of the structure of the market given in section 2.2. and 2.3 we conclude that the Dutch market is a national market. That is not to say that it is a closed market: it is open to foreign insurance companies and brokers. Indeed, some of the largest brokers and insurers active on the Dutch markets are of foreign origin.

4.2 View of the Dutch Competition Authority versus the view of the EC

Both the Dutch Competition Authority (NMa) and the European Commission launched inquiries into the coinsurance market. Although these inquiries both focus on the same period (NMa researches 2005, whereas EC looks at 2005 and 2006), concentrate on a general market analysis (that is not a case specific analysis), and include primarily structural market characteristics, their conclusions are remarkably different. NMa gives the following reason for their sector inquiry:

“On the market for coinsurance, far-reaching co-operation occurs between insurers. This is permissible under certain conditions in accordance with the Block Exemption for the insurance sector. There are also intensive contacts between insurers and insurance intermediaries active on the insurance exchange, referred to as insurance brokers. In addition, the market has a high degree of concentration and the number of providers on the coinsurance market has decreased in recent years. Finally, the market has a strong tendering character: the same risks are often offered each year by the same insurance brokers to the same insurers. These factors were the reason to examine the Dutch coinsurance market from the perspective of economic competition.”

The conclusion that is reached by NMa is as follows:

“For medium-sized companies, the provincial non-life market is an alternative to coinsurance. Considerably more insurers are active on the total (provincial) non-life market than are active on the coinsurance exchange. This means that a high degree of concentration on the coinsurance exchange does not necessarily indicate that competition is restricted. Entries and exits on the insurance exchange are possible and do, in fact, occur. The insurance exchange in the Netherlands shows that entries and exits occurred in the period 1990-2003 both amongst insurers and amongst insurance brokers. On the

provider side (insurers), this sometimes involved parties which had been active earlier on the market. Due to the short duration of contracts, it is easy, in principle, to switch, but due to the small group of insurers policyholders do not have much choice. This description of the market structure points in the direction of a limited risk to economic competition.

On the market for coinsurance, however, far-reaching co-operation takes place between insurers. The contacts between insurers and insurance brokers are also intensive and coinsurance has the character of a tender market. These factors, both separately and in relationship to each other, do give rise to risks to economic competition. Continuing competition regulation is desirable from this point of view. Finally, VNAB makes various demands on parties who wish to be active on the insurance exchange. From the perspective of competition, it is important that these requirements meet the criteria of objectivity, transparency and independence, as set out in the Guidelines for Cooperation between Undertakings.”

Summarising this conclusion: NMa sees no specific competition problems, but merely states that general competition regulation is important due to risks that are inherent to the character of the coinsurance product (that is, horizontal co-operation between insurers and brokers). Of course, NMa is cautious that in the future specific cases will not arise, but the authority concludes that the general regulation suffices.

On the other hand, the EC concludes that on top of these general cautiousness specific competition problems do exist, namely: the issue of alignment of terms and conditions in ad hoc coinsurance and reinsurance; the structure, function and mode of remuneration of distribution channels; horizontal co-operation among insurers including the Block Exemption Regulation; and duration of contracts. The EC plans to further investigate these issues “with a view either to clarifying the situation, modifying behaviour, or, if necessary, proposing enforcement proceedings”.

One possible explanation for this remarkable difference in the tone and content of the conclusions is that the analysis in the EC final inquiry on the coinsurance market was based on a less extensive research of the Dutch coinsurance market. The reason for this is that the Commission studied a large number of national markets, and it therefore had to spread their research efforts. Consequently, the EC inquiry, does not reckon or reckons much less with the typical *Dutch coinsurance* market.

An exception to this is the research of the Dutch market to look further at the question of long-term agreements. Questionnaires were sent to insurance supervisors, associations and national competition authorities in the four Member States identified as potentially concerned in the Interim Report, namely Austria, Italy, the Netherlands and Slovenia. As we described in section 2.5 the reality in the Netherlands is at odds with the remarks that the European Commission makes about the renewal of contract. Although it is not explicitly stated, we assume that the responses to the questionnaires of the Commission were sufficiently reassuring to recognise that the problems raised earlier in their report with respect to contract duration in the Netherlands are resolved.

4.3 Conclusions

In this chapter we conclude that:

Based on the low of the share of foreign risks contracted by Dutch insurers and the low share of risks placed overseas by Dutch customers, perceptions from the interviews as well as the description of the structure of the market given in section 2.2. and 2.3 we conclude that the Dutch market is a national market. That is not to say that it is a closed market: it is open to foreign insurance companies and brokers. Indeed, some of the largest brokers and insurers active on the Dutch markets are of foreign origin.

Both NMa and the EC launched inquiries into the coinsurance market. Although these inquiries both focus on the same period, concentrate on a general market analysis (that is not a case specific analysis), and include primarily structural market characteristics, their conclusions are remarkably different. Whereas NMa sees no specific competition problems, but merely states that general competition regulation is important due to risks that are inherent to the character of the coinsurance product (that is, horizontal co-operation between insurers and brokers), the EC concludes that actual competition problems do exist. One possible explanation for this difference in the tone and content of the conclusions is that the analysis in the EC inquiry was based on a less extensive research of the Dutch coinsurance market. Consequently, the EC inquiry, does not reckon or reckons much less with the typical *Dutch coinsurance* market.

Appendix A Literature

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