PRESERVING COMPETITION: BEST PRACTICE IN HORIZONTAL RISK SHARING BETWEEN INVESTMENT INSURERS

A discussion paper on the syndication of PRI Policies between ECAs, Multilaterals and Private Market Insurers by Charles Berry, Chairman, BPL Global

> **"People of the same trade seldom meet together, even for merriment or diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."**
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> **Adam Smith, *The Wealth of Nations***

INTRODUCTION

Adam Smith wrote these words over 200 years ago, before markets were governed by competition law. In layman's terms, competition law prevents undertakings operating at the same level in the market from speaking to each other about the terms of their commercial offering to clients. Undertakings operate at the same level of the market if the client can exercise choice between them.

The insurance industry is subject to competition law. Essentially this means that insurers cannot speak to each other about the terms and conditions they offer prospective policyholders when responding to a request for cover. When a specific risk is small and can be written in full by only one insurer, the matter is simple: if two insurers bidding for that business speak to each other and agree the commercial terms they intend to offer for that business, they would be colluding.

But what happens when the risk is large and so requires the combined resources of several insurers? In the subscription market – the London and international insurance market handling large and complex risks – placements typically involve a number of insurers, each writing the risk on the same terms and at the same price. As political risk insurance (PRI) brokers we are part of the subscription market and routinely arrange such syndications among groups of insurers.

During its recent sector enquiry into business insurance in Europe, the European Commission became very interested in the subscription market. Competition law applies to the placement of large risks. So the authorities focused in particular on the price harmonization that occurs in the subscription market. How, they asked, can this harmonization of pricing come about without the insurers talking to each other? Is not the fact of price harmonization between insurers itself evidence of collusion? Indeed, is harmonization of pricing necessary at all in the subscription market? Why not ask each insurer to quote a price for the percentage of the risk it wants to write, and fill out the placement at different prices – so called "vertical" syndication?

THE COMPETITIVE DYNAMICS OF THE SUBSCRIPTION MARKET

The response from the subscription market was very robust. It is not in denial of Adam Smith's famous observation; rather it embraces it. The "Golden Rule" of the subscription market is that the participating insurers do not talk to each other during the placement negotiations. The subscription market process is controlled by the client, acting through its agent, the broker. Each insurer obeys the Golden Rule and speaks only to the client and broker during the placement process. Furthermore, when client and broker harmonize prices, they harmonize them downwards to the lower price of the lead insurer they have chosen.

The genius of the subscription market is therefore that it enables large and complex risks to be shared "horizontally", meaning between insurers operating at the same level of the market, without upsetting the competitive dynamics of a normal bidding process. Each insurer still has to compete for the leadership of or a participation in the placement. As a result, the subscription market is, in reality, very competitive.

Despite this robust response, the European Commission still dedicated 19 pages of its 97 page Final Report to the workings of the subscription market. This indicates that the competition authorities in Europe, and I suspect elsewhere, remain suspicious of all "horizontal" risk sharing in which the participating insurers write an individual risk on the same terms, and in particular, at the same price.

This interest of competition authorities in risk sharing between insurers operating at the same level of the market should be noted by all of us in the "Great Mall". In referring to the Great Mall I am using the memorable expression of Lars Kolte, former head of EKF and the Berne Union, to describe the wider PRI market consisting of ECAs, multilateral agencies and private insurers. Public and private insurers in the Great Mall operate at the same level of the market when they offer insurance policies providing essentially the same form of cover, for example, their offerings on equity and lenders' investment insurance policies.

THE COLLEGIATE APPROACH OF THE ECAs AND MULTILATERALS

Of course all our PRI placements involving just private sector insurers follow the rules of the subscription market. However, not all risk sharing across the Great Mall follows this route. The ECAs and Multilaterals have developed a different, more collegiate approach: when sharing individual risks between themselves, they do talk to each other.

Despite the fact that ECAs and Multilaterals do not follow the Golden Rule of the subscription market, I would fully defend their practices for sharing risks between themselves. ECAs and Multilaterals operate in a very different environment. While encouraging competition between private insurers, governments seek to limit competition between ECAs and Multilaterals. For example, unfettered competition between ECAs would be undesirable as it would distort the international trade in goods and services. Additionally, ECAs and Multilaterals exist to fulfill a public purpose: Adam Smith's comment was an insight into the behaviour of those who are motivated by profit, not public service.

Therefore in the context of sharing risks between ECAs, or between an ECA and a Multilateral, the collegiate practices of entering into "co-operation agreements", and of discussing the terms and pricing of individual cases between themselves, makes perfect sense. But should ECAs and Multilaterals bring these practices into the private arena?

PUBLIC / PRIVATE RISK SHARING

Clients and brokers welcome the ECAs and Multilaterals in the Great Mall. They bring capacity, expertise, experience, financial security and their "umbrella". They add choice and diversity which we like. But which approach should govern risk sharing between the public and private sector insurers: the competitive dynamics of the subscription market? Or the collegiate approach of the ECAs? This question has assumed renewed importance as we are seeing increasing demand for investment insurance policies, and we see this demand needing to be met by increased risk sharing between public and private insurers, whether by co-insurance or facultative reinsurance.

Co-insurance

Addressing co-insurance arrangements first, there seems little room for doubt that where ECAs or Multilaterals co-insure a risk with private insurers, the rules of the subscription market need to apply. Co-insurance always consists of "horizontal" risk sharing: by definition, participating insurers, whether public or private, are operating at the same level of the market. Competition authorities are clear that they do not want undertakings operating at the same level of the market talking about the terms and pricing of specific risks. In my view the obvious, indeed the only, solution is therefore that of the client led subscription market, with its Golden Rule that insurers do not talk to each other during the placement negotiations.

Given the European Commission's views on the subscription market, and its continuing interest in it, I would be surprised if any ECA or Multilateral would want to do other than conform to subscription market best practice for all public / private co-insurance arrangements. I say this not least of all as this is not new ground. We regularly effect placements led by private insurers but with ECA and private market following participations, where everyone follows the subscription market conventions, including the Golden Rule. Co-insurances led by ECAs or Multilaterals with private insurers following are less common, but again, I would be surprised if all involved failed to follow subscription market best practice.

The only note of controversy about co-insurance practice I anticipate going forward is over "best terms" clauses (a practice the European Commission want phased out altogether) and the auctioning of following market participations to the lowest bidder (a practice it wants to see phased in). Either or both may increase the frequency of "vertical" co-insurance placements, meaning that some insurers participate at different prices to others. The subscription market is currently still taking these issues on board, so I will leave them for another day, except to say I still anticipate that most of our placements, but not all, will involve all insurers participating at the same, downwardly harmonized rate.

Facultative reinsurance

In the general insurance market it is rare for facultative reinsurance to be arranged "horizontally" between insurers operating at the same level. Facultative reinsurance is usually placed with the specialist reinsurers, who operate at a different level in the market to their ceding insurers.

Indeed, if we were placing a large risk in the subscription market, and an insurer offered to write the risk 100% and "save us the walk" by itself placing a facultative reinsurance with its fellow underwriters in the direct market, we would reject the offer. We would regard it as no more than a "contrivance to raise prices"; an excuse for the insurer to speak to its fellow insurers, thereby breaking the Golden Rule, and (very possibly) competition law.

However, we recognize that for large policies in the PRI market, if ECAs and Multilaterals write a risk in full and reinsure part of the risk to other private market direct insurers there may be advantages to clients of financial security, the "umbrella" effect, and so on. But these types of facultative reinsurance are unusual as they are "horizontal". It is important therefore that they come about at the client's choice, and not simply because they suit the insurers; it is important that the benefits of these arrangements flow to the clients, not merely to the private insurers; and it is important that the investigation of such arrangements increase the client's options, and do not eliminate other possible alternative choices that the client may ultimately prefer.

To ensure this happens, it is necessary, in my view, for these arrangements to follow the subscription market rules during the key negotiation phase of the reinsurance. In other words, the negotiations need to be in the hands of the client, not the ECA or Multilateral; and all the insurers involved need to obey the Golden Rule and not talk to each other. Of course I recognize that the reinsurance contract would ultimately have to be placed by the ECA or Multilateral. I therefore envisage two distinct phases: negotiation handled by the client; and (assuming the client finally decides on the facultative reinsurance route) placement handled by the ECA or Multilateral. The passage from the negotiation phase to the placement phase would be marked by a mandate letter issued by the client, specifying the terms, participations and pricing of the facultative reinsurance placement. Issuance of this mandate letter would mirror practice in the banking syndication market where mandate letters are issued after the client (the borrower in their case) has concluded negotiations in the market, not before. The mandate letters would then specify the terms, conditions and pricing of the transaction to be executed.

These views are best explained using a hypothetical example. This example has been designed as an illustration, and is not based on any specific case involving public / private risk sharing. The example looks at three separate placing scenarios for the same risk: the first, involving only private market insurers; the second, introducing an ECA who does not follow the above rules; and the third, with the ECA following the two-phase approach.

SCENARIO 1: PRIVATE MARKET ONLY

A client seeks USD150 million of investment insurance cover from the market for a seven year period. In this Scenario 1, it approaches only the private market and obtains terms from four different insurers, each for a participation of USD50 million. The terms provided are as follows:

Scenario 1

Insurer	Participation	Rate per annum
A	USD 50 million	0.65%
B	USD 50 million	0.75%
C	USD 50 million	0.85%
D	USD 50 million	0.90%

By way of additional background, the placement is for a risk in a medium risk emerging market, but one where the market's aggregate exposure is quite low. Insurers A, B and C are well established and respected leads. Insurer D is a relatively new entrant to the market.

Armed with these responses, the client is ideally placed to benefit from the competitive dynamics of the subscription market. It should be able to complete the whole placement at the lowest indicated rate of 0.65%.

Of course, these competitive dynamics are underpinned by the Golden Rule. Obviously, if Insurers B and C, for example, got together and agreed a price, whether B's price of 0.75% or C's of 0.85%, they would be able to dictate price to the client. Such a blatant arrangement would obviously breach competition law. However, my point is that any communication between Insurers A, B, C and D could upset the competitive dynamics of the negotiation.

The key phase in the negotiations will be when the client approaches Insurer B and asks them to follow Insurer A's rate of 0.65%. Insurer B now has to decide whether to follow Insurer A, or hold out for its own price of 0.75%, knowing that if it holds out, it could well miss out on the business altogether if others follow Insurer A's lead. Insurer B has to make this decision in isolation, not knowing what the other insurers will do: indeed, Insurer B may well not know which other insurers are still in the game and at what price.

Of course, while contemplating its response, it would be extremely useful for Insurer B to receive a message from Insurer C encouraging it to hold out for a higher price. This more subtle collusion would be an example of the "smoking gun" that the European competition authorities were looking for in the subscription market, but did not find.

Needless to say, I am confident all our underwriters in the private sector understand and obey the Golden Rule. Because of this, I would expect that Insurer B will follow Insurer A's lead, and that the client will complete the risk at Insurer A's 0.65% rate, not least as on this occasion the client has correctly deduced that Insurer D's response at the tendering stage indicated that they would prefer to follow an established lead, rather than lead the risk themselves.

SCENARIO 2: THE EFFECT OF AN ECA's COLLEGIATE APPROACH

Under Scenario 2, the client approaches the private insurers and an ECA.

The ECA is also only able to retain a USD 50 million participation on this risk for its own account. Additionally, it does not want to be a price leader. So with or without the consent of the client (it makes no difference) it contacts Insurers B and C to investigate market pricing and discuss co-operation through facultative reinsurance.

Insurers B and C have now been approached both by the client direct and by the ECA. Both Insurers B and C decide, quite separately, to respond to the ECA, and not to the client. Given the choice, this is the sensible commercial decision for both, given the ECA's "umbrella". In co-operating with the ECA, they would then not want in effect to compete with themselves by also quoting direct to the client.

The ECA obtains pricing indications of 0.75% and 0.85% for Insurers B and C respectively. In the spirit of compromise, they agree to split the difference and the ECA now offers the client a complete solution: the full USD 150 million at a price that comes from the market of 0.80%.

Therefore under Scenario 2 the client receives the following responses:

Scenario 2

Insurer	Participation	Rate per annum
A	USD 50 million	0.65%
B	No quote	-
C	No quote	-
D	USD 50 million	0.90%
ECA	USD 150 million	0.80%

The client is now in effect faced with only one option: that offered by the ECA.

It is clear that the ECA, by breaching the Golden Rule and speaking to the private insurers, has inadvertently but completely destroyed the competitive dynamics of the negotiation from the client's point of view. Rather than providing additional choice it has eliminated choice.

By taking Insurers B and C out of the direct market, the ECA has isolated Insurer A's competitive quote, and rendered it useless to the client, as there is now not enough capacity left in the private market to complete the risk behind A's lead.

The ECA has acted only with the best of intentions: Insurers B and C have fulfilled their fiduciary responsibility to their capital providers by opting for the route that serves them best. However, the upshot is that the ECA has disrupted the competitive dynamics of the subscription market, and produced an outcome at a price that is higher than that achieved under Scenario 1.

Market distortion will not always be the outcome of an ECA or Multilateral breaking the Golden Rule; but sooner or later a market distortion as illustrated in this hypothetical case will inevitably occur.

THE MARKET GAP

The ECA does not know of the offerings from Insurers A and D, and did not approach them for facultative reinsurance because they have not signed a "co-operation agreement" with them. In due course the ECA hears from the client that its solution is the only one on the table. As the ECA's offer could not have been achieved without their USD 50 million participation, the ECA is now convinced in its mind that the case is a good example of it operating in the "market gap".

This of course is a travesty. As Scenario 1 shows, there is no "market gap" for this case. Far from operating in the "market gap", the ECA has inadvertently orchestrated an outcome very similar to the one that would have resulted had a real "conspiracy" of the type contemplated by Adam Smith occurred between Insurers B and C in Scenario 1. Accidents, and worse, may well happen if insurers talk to each other about a specific case.

This leads to a very important lesson: ECAs and Multilaterals cannot identify a "market gap" by speaking to the private market insurers. As soon as an ECA picks up the telephone to a private insurer to discuss a specific case, it begins to alter the competitive dynamics of the case.

The only entity capable of establishing whether a "market gap" exists for a particular enquiry is the client itself, and the client can identify the existence of a genuine "market gap" only when all the insurers in the Great Mall, including the ECAs and the Multilaterals, obey the Golden Rule and refrain from talking to each other about the specific enquiry.

SCENARIO 3: APPLYING SUBSCRIPTION MARKET RULES IN THE GREAT MALL

Best practice is illustrated in Scenario 3 of my hypothetical example. Here the client approaches the private market and the ECA as before, but this time, on advice, insists that the ECA avoids speaking to any private insurers and only addresses what it can provide from its own resources. The ECA therefore has three options: to decline the risk; to provide lead terms for its USD 50 million internal capacity; or indicate that it will not lead, but would be willing to follow a private market lead.

In this case the ECA indicates that on a co-insurance basis it will follow with its USD 50 million line, but does not want to set a price. So the client at the end of the initial tendering stage of the process has the following offers:

Scenario 3

Insurer	Participation	Rate per annum
A	USD 50 million	0.65%
B	USD 50 million	0.75%
C	USD 50 million	0.85%
D	USD 50 million	0.90%
ECA	USD 50 million	As per private market lead

In addition the client has sounded out all the insurers on facultative reinsurance. The ECA indicates that it would be willing to write the risk 100% and reinsure two thirds to Insurers A, B and C, but not D, who is not on its security list. All the private insurers indicate that they would look favourably on a structure that had them reinsuring the ECA.

It is time for the client to huddle with its advisors. For a co-insurance placement they now have a wider choice than under Scenario 1 as completing a co-insurance behind Insurer A's lead should be even easier, now that the ECA is also in play. But on this occasion, the client is attracted to the idea of the ECA fronting, particularly as there is scope for further downward pressure on the private insurers' rates under this structure.

The client goes back to Insurer A and obtains a rate concession: 0.60% if Insurer A has the benefit of the ECA's front. Insurer B is approached for support: the 0.60% rate is slightly less than it hoped for; but it knows when a proposal looks as if it will work in the market; and there is the advantage of the ECAs involvement; and it knows Insurer C is always keen to reinsure ECAs. Insurer B agrees to support the 0.60% rate on the reinsurance structure.

The client now goes back to the ECA with USD 100 million of facultative reinsurance lined up at a rate of 0.60%. The ECA will want some ceding commission of course, but that can come from the normal commissions included in the private insurers' rates. The client therefore issues a mandate letter to the ECA specifying USD 150 million of cover and a rate of 0.60%, and points the ECA in the direction of Insurers A and B to fill out the placement. Up to this point all negotiations have been between the client and each insurer separately (whether ECA or private). No discussions have taken place between any of the insurers.

The outcome of Scenario 3 is a 25% price improvement on Scenario 2. The structure is of course the same: the difference is only in the process. Scenario 3 is also an improvement on Scenario 1, demonstrating the benefits that can flow to the client from the ECAs' and Multilaterals' presence in the market in the form of increased choice – provided always of course, they do not risk eliminating choice by failing to comply with the Golden Rule.

COVERAGE & WORDING NEGOTIATIONS

The competitive dynamics of the subscription market are intended to work in exactly the same way on coverage and material wording issues as on price. In the PRI market, scope of coverage (meaning wording) can be as important a part of the commercial offering as pricing, or more important. Indeed, the client is likely to choose the insurer to lead a placement based on a combination of both price and coverage, and then utilize the competitive dynamics to persuade others to follow. Exemptions to competition law in the area of wordings do not authorize insurers to speak to each other about the wording of a specific case.

CONCLUSION

My example produces three very different results, depending on the negotiation process. These results can be summarized as follows:

Scenario	Policy Limit	Structure	Rate per annum
1	USD 150 mill	Coinsurance: Insurers A,B & D	0.65%
2	USD 150 mill	ECA (with private fac. R/I)	0.80%
3	USD 150 mill	ECA (with private fac. R/I)	0.60%

The best solution on this occasion is an ECA policy supported by private sector facultative reinsurance. But does the client want to pay 0.80% per annum or 0.60% per annum?

The higher price of Scenario 2 is the product of the ECA ignoring subscription market practice and itself syndicating part of the risk to the private market. The lower price of Scenario 3 came from the client successfully using the competitive dynamics of the subscription market.

We are only asking ECAs and Multilaterals to refrain from talking to private insurers while clients are negotiating coverage in the market. There is still much for the reinsurance and syndication departments of ECAs and Multilaterals to do including: arranging facultative reinsurance with private direct insurers in the Great Mall for exposures already on their books; arranging (re)insurance with the same private insurers when they are not operating at the same level of the market (for example when an ECA acts as a direct lender); arranging facultative reinsurance with specialist reinsurers; and of course arranging treaty reinsurance.

We also accept that the Berne Union remains a forum in which it is entirely appropriate for public and private insurers to meet to discuss issues of common interest. The process of “horizontal” risk sharing between public and private insurers is just such an issue for them to review.

In the meantime, we believe, ECAs and Multilaterals should follow subscription market best practice. To ensure this happens, we recommend to clients that when approaching ECAs and Multilaterals, they ask them to abstain from any discussions “horizontally” across the market, unless and until the client issues a mandate letter in the form we have described, specifying terms and pricing. Our concern is that if ECAs and Multilaterals talk to private insurers while the client is still in negotiation with the private market, they will disrupt the competitive dynamics of the negotiation, and the type of market distortion illustrated in Scenario 2 of my hypothetical example, will occur in practice.

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