

Prof. Dr. Pierpaolo MARANO\*

## WHICH REGULATION FOR THE REINSURANCE INTERMEDIARIES: PRESENT AND FUTURE OF THE DIREC- TIVE 2002/92/EC

### ABSTRACT

*Author considers numerous consequences of non-regulation of reinsurance mediation by the Directive 2002/92/EC on insurance mediation. Author devotes special attention to the necessity to apply rules of insurance mediation regarding clear communication and duty to provide documents to reinsurance mediation and analyzes indirect impact of non-existence of the codes of conduct in reinsurance mediation and unfair competition on insurance price. Author provides certain suggestions to counteract these drawbacks for the forthcoming launch of the procedure of revising the said Directive.*

*Key Words: Reinsurance Intermediaries, Reinsurance Regulation, Reinsurance Mediation, unfair Practices*

Directive 2002/92/EC on insurance mediation is focused on intermediary activity, because this is the way to overcome the substantial differences between national provisions which created barriers to the taking-up and pursuit of the activities of reinsurance (and insurance) intermediaries in the EU Single Market, in spite of the former Council Directive 77/92/EEC of 13 December 1976.

The abovementioned Directive underlines the role played by all intermediaries<sup>1</sup>, and intends to harmonize the corresponding rules, but provides few and very general rules on reinsurance (mediation and intermediaries), thus leaving the power to legislate on them, in large part, in the hands of the member States.

In particular, after the definition of the reinsurance (and insurance) mediation, the Directive 2002/92/EC di-

stinguishes between access rules and business conduct rules: the former are used to so called Single Passport for all intermediaries, insurance and reinsurance, the latter concern only the insurance intermediaries, moreover with the exception of the large risks that they broker.

Is it possible to identify a rationale that would explain the adoption of this different approach in the regulation of such intermediaries?

From a general point of view, an effective regulation of the intermediaries should maintain the stability of the insurance market and, at the same time, promote fair competition.<sup>2</sup>

This means that the regulation must focus on the relationship between intermediaries and their principals ensuring that intermediaries' duties are always defined and clearly identifiable; but also means that regulation should not overlook the impact of intermediaries' misconduct towards third parties.

Of course, the rules applicable to reinsurance intermediaries should not necessarily replicate exactly those for insurance intermediaries, since the needs of protection met by each of these disciplines may not be identical. However, it should not be neglected the common risk of reinsurance undertakings declaring bankruptcy and the consequent effects this would have on the first insured. On the other hand, there are a number of small insurance companies which rely on big reinsurance intermediaries to place the risk to reinsurance undertakings that the intermediaries have chosen.<sup>3</sup>

Notwithstanding that insurers' customers do not have any contractual relationship with the reinsurance intermediaries, the business conduct of these intermediaries may have a strong negative impact also on the contractual relationship the customers have with their own insurers, as I try to say in more detail later. Regulatory approach should prevent improper business conduct, or at least its negative impact, from occurring, although must distinguish between rules that protect the interests concerning only the relationship between consumers and insurance undertakings<sup>4</sup>, and rules that promote transparency in the re-

\* Professor of University of Calabria.

<sup>1</sup> Recital n. 1 of Directive 2002/92/EC on insurance mediation says that: "Insurance and reinsurance intermediaries play a central role in the distribution of insurance and reinsurance products in the Community".

<sup>2</sup> HSIN-CHUN WANG, W, *Reinsurance regulation. A contemporary and Comparative Study*, Kluwer Law International, London-The Hague-New York, 2003, p. 112.

<sup>3</sup> In this regard, see HSIN-CHUN WANG, W., *supra* note 2, pp. 89 ff.

<sup>4</sup> Reinsurer and ceding insurer, in fact, are generally expected to be knowledgeable about the insurance business. Therefore, the oversight necessary in primary insurance to protect consumer interests is not essential in the reinsurance business.

insurance market also in the interest of consumers and insurance undertakings.<sup>5</sup>

On the basis of the above considerations, the next section will consider the provisions of the Directive 2002/92/CE related to the reinsurance intermediaries. The aim is to ascertain if the current regulation is complied to the principles pointed out before.

As noted above, the goals of a viable regulation of reinsurance intermediaries are to maintain the stability of insurance market and to promote fair competition. Bearing this in mind, this section will examine EU model of regulation in detail and distinguishing between access rules and business conduct rules.

Directive 2002/92/CE adopt an approach that requires proper authorization under the form of a registration procedure (EU), with (insurance and reinsurance) intermediaries required to obtain the proper authorization to carry on their business,<sup>6</sup> and insurance and reinsurance undertakings prohibited from using services of unregistered intermediaries.<sup>7</sup> The rationale for this provision should be that the above certifying requirements are able to assess the fitness and propriety of management consisting of the competence, practical experience and suitability of key staff including the major shareholders.<sup>8</sup>

To this purpose, art. 4 of Directive 2002/92/EC requests reinsurance intermediaries to possess appropriate knowledge and ability, as determined by the home Member State of the intermediary, and to be of a good repute.<sup>9</sup> However, the contents of these provi-

sions are not uniform throughout the EU Single Market. The Member States and their supervisory authorities must trust each other in the absence of uniform and detailed requirements because the authorization given to an intermediary based in a Member State (home state), in accordance with the rules of that state, enables its activity in the others (host states) in accordance with the principles of freedom of establishment and freedom to provide services.<sup>10</sup>

The construction of an effective Single Market requires the establishment of uniform rules and amendments to the Directive 2002/92/EC should not shy away from the identification with those rules, if they want to reach the above purpose. In a "step by step" approach to the Single Market, these rules could result from the recognition of the national rules that have implemented the Directive 2002/92/EC with respect to reinsurance intermediaries.

In any case, it would be desirable to introduce a uniform rule that provides for the possibility to refuse to grant the registration if any controlling person of the applicant intermediary is not trustworthy to act as reinsurance intermediary", because of the importance of such a rule from a supervisory point of view.<sup>12</sup>

Moreover, Directive 2002/92/EC currently provides that the Member State shall take a measure as a requirement to have financial capacity amounting, on a permanent basis, to 4 % of the sum of annual premiums received, subject to a minimum of EUR 15,000.<sup>13</sup> This provision, however, is referred only to insurance

<sup>5</sup> O'NEIL, P.T. - WOLONIECKI, J.W., *The Law of Reinsurance in England and Bermuda*, Sweet & Maxwell, London, 2004, p. 523 underline that "there is a sense that reinsurance intermediaries do not require the same amount of regulation and supervision as insurance intermediaries because reinsurance intermediaries deal with people already in the insurance business not "lay" clients", but their conclusion is that "We cannot see that they can be so different, insurance intermediary to reinsurance intermediary and the cost of framing and regulating a two-tier system and its effect on the mobility of individuals admitted for one and not the other, argues against it". A different opinion seems to be expressed from HSIN-CHUN WANG, W., supra note 2, p. 113: "While the reinsurance intermediary generally deals with professional enterprises, it is suggested that differences between the reinsurance intermediary and insurance intermediary should be drawn and the flexibility of the regulation should be enhanced to prevent the distortion of reinsurance business".

<sup>6</sup> Section 3 of the Reinsurance Intermediary Model Act and art.3, par. 1, Directive 2002/92/EC.

<sup>7</sup> Section 16 of the Reinsurance Intermediary Model Act and art.8, par. 2, Directive 2002/92/EC.

<sup>8</sup> HSIN-CHUN WANG, W., supra note 2, pp. 117 f.

<sup>9</sup> Art.4, par. 2, besides, states that: "as a minimum, they shall have a clean police record or any other national equivalent in relation to serious criminal offences linked to crimes against property or other crimes related to financial activities and they should not have previously been declared bankrupt, unless they have been rehabilitated in accordance with national law".

<sup>10</sup> On supervisors' liability in the EU, see COUSSY, H., "L'arroseur arrose" ou quelques considerations sur la responsabilite civile des autorites de surveillance du secteur financier, in Etude offert a Hubert Groutel, Responsabilite civile et assurances, LexisNexis Litec, Paris, 2006, (2006), pp. 105 ff.

<sup>11</sup> Section 3, subsection E), adds: "or (...) has given cause for revocation or suspension of such license, or has failed to comply with any prerequisite for the issuance of such license".

<sup>12</sup> HSIN-CHUN WANG, W., supra note 2, p. 113.

<sup>13</sup> Art. 4, par. 4, let. b).

intermediaries, while it is quite evident the need to extend to reinsurance intermediaries the requirement to hold a certain amount of professional indemnity insurance against any legal liability arising from professional negligence in connection with the activity.<sup>14</sup>

Moving to the business conduct rules, in carrying out its activity the intermediary must observe the rules of conduct of the market in which business is undertaken, since the Directive 2002/92/EC has no provision on the business conduct of reinsurance intermediaries. Even the weak rules on conflict of interest, which require (insurance) intermediaries to disclose to costumers the relationship with insurance undertakings<sup>15</sup>, do not apply to reinsurance intermediaries.<sup>16</sup>

Unquestionably recital n. 21 of the Directive 2002/92/EC says that there is less of a need to require that information be disclosed when the customer is a company seeking reinsurance. Nevertheless, it does not seem that no information shall be provided by reinsurance intermediaries. The absence of rules on this specific issue appears to be in conflict with the recital n. 17, under which the cooperation and exchange of information between competent authorities are essential in order to protect customers and ensure the soundness of "insurance and" reinsurance business in the single market. Under the principle of mutual recognition, in fact, the cooperation between the supervisory authorities must relate to profiles concerning the pursuit of activity, not the access. It is difficult to envision mutual recognition taking place unless the business conduct rules of reinsurance intermediaries are entirely not harmonized.

Requiring intermediaries to possess appropriate knowledge and ability, besides, art. 4, and par. 1, of the Directive 2002/92/EC seems also to fix the principle that intermediaries' activity must be carried out according to these skills: otherwise, the above requi-

rement does not make sense. Because the objective is to create a Single Market, this principle should have been specified in detail by the Directive, in a way that makes it possible, in any case, for an intermediary to meet high standards of competence and integrity in carrying on its business.<sup>17</sup> Moreover, this specification would be useful to guide the decisions of the Courts<sup>18</sup>, in addition to preventing improper conduct of intermediaries.

Once more, Directive 2002/92/EC does not set any rule that provides for clear communication between the parties and for documentation about the transaction with the principal, nor does it require that the intermediary provide an account of claims information and fund collected. Moreover, the provision of a separate account is one of the measures taken into account by art. 4 of Directive 2002/92/EC to protect customers against the inability of the intermediary to transfer the premium to the insurance undertaking, or to transfer the amount of claim or return premium to the insured. Surprisingly, this provision is applicable only to insurance intermediaries ignoring, as well, the role that it can also play in preventing a misconduct of reinsurance intermediaries from a supervisory point of view.<sup>19</sup> In addition, some intermediaries could also be authorized to perform both reinsurance and insurance mediation, with the obligation to keep a separate account for only the last one of those activities.

On the basis of all the above considerations, it would be advisable that a cost/benefit analysis – at least – should be performed to support any, persistent, choice in the EU for a regulation that aims to protect policyholders with rules that tend to discipline their relationship with the insurers, but fail to deal with the relationship that exists between these latest and the reinsurers, despite of the connection between one and the other. On the other hand, there is no evidence in any

<sup>14</sup> SCHWAB, S.W., GALLANIS, P.G., MENDELSON, D.E., RITTER, B.V., *Caught between Rocks and Hard Places: The Plight of Reinsurance Intermediaries Under U.S. and English law*(1995), 16 *Mich. J. Int'l L.*, 485, 521 point out that this rule provide protection in the event of insolvency, not only of the intermediary, but also the cedent or reinsurer in the event of insolvency of the other.

<sup>15</sup> Art. 12, par. 1, let. c) and d).

<sup>16</sup> As regards the position of conflict of interest of a broker who acts for an assured in placing insurance, and then for insurers in placing reinsurance, see *Colinvaux's Law of Insurance*, edited by Robert Merkin, London, Sweet & Maxwell, , 2006, p.531.

<sup>17</sup> Alternatively, the Directive would specifically provide that such rules are established by the insurance industry at European level. This choice, however, should be accompanied by the principles upon which the self-regulation should be guided and, above all, by identifying the interests that must be protected. For an example of self-regulation, although currently it is not binding, see BIPAR *Principles on transparency in insurance* (June), from [www.bipar.eu/Portals/13/Public%20paper-2008-BIPAR%20principles%20transparency-EN.pdf](http://www.bipar.eu/Portals/13/Public%20paper-2008-BIPAR%20principles%20transparency-EN.pdf), accessed 24 April 2009.

<sup>18</sup> A list of these issues can be read in HSIN-CHUN WANG, W., *supra* note 2, p. 118.

<sup>19</sup> HSIN-CHUN WANG, W., *supra* note 2, p.117, where he points out that insurance monies held by the intermediary should be maintained in a segregated account and separated from the general assets of the intermediary avoiding, in the event of its bankruptcy, to use these accounts to reimburse other creditors.

economic survey that the current absence of business conduct rules is the optimal solution for the intermediaries operating in an efficient reinsurance market.

Insurers' solvency – as noted before - has always been the main goal of the regulation of reinsurance. With reference to reinsurance intermediaries, the security of their performance is provided, at least to a certain extent, by the above registration procedures; while, on the other hand, in the performance of their businesses, such intermediaries are under duties of business conduct that are not harmonized within the EU. Outside of this profile, however, the impact of reinsurance market practices on the relationship between insurer and policyholder has been almost neglected by regulators (and supervisors).

Their approach, in fact, do not seem to take into account the costs incurred by the policyholders in procuring insurance coverage. Anticompetitive practices in the reinsurance market could conceivably raise the costs for the insurers buying reinsurance, which ultimately are paid by the policyholders. Therefore, a lack of competitiveness in the reinsurance market would have an impact also on the economic substance of the underlying insurance contract between insurer and policyholder.

The awareness of this impact, however, is now emerging. EU Commission - DG Competition, after an *interim* report of January 2007, posted the final version of the Inquiry into the European business insurance sector on December 2007.<sup>20</sup> The Inquiry aimed at better understanding the functioning of the writing and distribution of business insurance with a view to ultimately identify any concrete restrictive practices or distortions of competition that may fall within the scope of Articles 81 or 82 of the Treaty.<sup>21</sup> This might further lead

to follow-up enforcement action either by the Commission or by national competition authorities within the European Competition Network.<sup>22</sup>

Looking at its findings, in the view of the Commission services, the agency nature of any agreement between broker and customer does not have the effect of removing the broker, in its capacity as an independent undertaking, from the obligation to respect the rules on competition<sup>23</sup>. Therefore, the relationship between insurer and broker does not fall *per se*<sup>24</sup> under the exceptions to Article 81 of the Treaty, fixed by §§ 12 ff. of the Commission's Guidelines on Vertical Restraints<sup>25</sup>

After this premise, the survey also pointed out that the so-called Best Terms and Conditions clauses (BTC)<sup>26</sup> - which seems to be a practice present in all lines of reinsurance within EU, albeit to differing degrees<sup>27</sup> - have the principal effect of aligning terms, conditions of coverage and premiums at levels which are, to a varying degree, detrimental to the (re)insured and which are correspondingly more favorable to the (re)insurers. Therefore, it would be desirable for brokers to systematically discuss with their clients all available options rather than exclude certain options in advance merely on the grounds that such options are contrary to established market practice. The harmonization of premiums at the highest level would also lead to higher brokerage fees for brokers in cases where the brokerage fee is calculated as a proportion of the premium.<sup>28</sup> In this case, brokers might not have an incentive to challenge the prevailing market practice.

The conclusion of the survey is that brokers could be parties, in certain instances, to arrangements which fall within the scope of Article 81(1), failing to stimulate possible competition on price, even in the absence of a BTC clause or explicit conditionally; whi-

<sup>20</sup> EUROPEAN COMMISSION. COMPETITION DG, *Business insurance sector inquiry. Final report* (December), from [www.europa.eu/comm/competition/sector/financial\\_services/overview/en.htm](http://www.europa.eu/comm/competition/sector/financial_services/overview/en.htm), accessed 24 April 2009.

<sup>21</sup> See the Consultation paper launched on April 2008 by the EU Commission on the functioning of the Insurance Block Exemption Regulation, from [http://ec.europa.eu/comm/competition/sector/financial\\_services/overview/en.html](http://ec.europa.eu/comm/competition/sector/financial_services/overview/en.html)

<sup>22</sup> EUROPEAN COMMISSION. COMPETITION DG, *supra* note 20, p. 1.

<sup>23</sup> EUROPEAN COMMISSION. COMPETITION DG, *supra* note 20, p. 37.

<sup>24</sup> EUROPEAN COMMISSION. COMPETITION DG (2007b), *supra* note 20, p. 37.

<sup>25</sup> Although exceptions remain possible: EUROPEAN COMMISSION. COMPETITION DG, *supra* note 20, pp. 37 f.

<sup>26</sup> Best Terms and Conditions clauses were defined by the EUROPEAN COMMISSION. COMPETITION DG, *supra* note 20, pp. 21 f., as follows: "Any stipulation, whether written or oral, introduced at any stage of the negotiation of a reinsurance contract, by means of which a (re)insurer A obtains, seeks to obtain or acquires the right, under certain circumstances, to obtain an alignment of its proposed or agreed terms and conditions, in particular the premium, to the terms and conditions ultimately obtained by any other (re)insurer B participating in (re)insuring the same (re)insured as A, in the event that the latter terms are more favorable to the (re)insurer, than the terms and conditions which A initially offered or subsequently agreed".

<sup>27</sup> EUROPEAN COMMISSION. COMPETITION DG, *supra* note 20, pp. 24 f. and 29.

<sup>28</sup> EUROPEAN COMMISSION. COMPETITION DG, *supra* note 20, p 31 adds: "and possibly also when the broker is remunerated on a fee basis, if in addition he receives contingent commissions based on profitability of the business placed".

le it is a matter of factual circumstances, which can only be fully determined on a case-by-case basis, whether there are efficiencies which meet the criteria of Article 81(3).

The Inquiry promoted by the Commission services shows the impact that the reinsurance market practices, and the possible behaviors of the intermediaries, could have on the economic substance of the insurance contract between insurers and policyholders, in terms of higher costs for the latter arising from the lack of competition. Reinsurance market practices could be inconsistent with competition law and create higher costs for insurers and their clients as a result of anticompetitive practices.

It may be the current rules are able to counteract such anti-competitive behaviors, perhaps on the basis of the next review of the Insurance Block Exemption Regulation.<sup>29</sup> However, the link between insurance market and reinsurance cannot be ignored by the regulators. This does not mean that reinsurance intermediaries should be subject to the same rules applicable to insurance intermediaries, but regulators should be more sensitive to the costs on insurers and insured that spring from the practices of the reinsurance market.

If business conduct rules will be introduced for reinsurance intermediaries, as I have advocated in this paper, the forthcoming amendments to Directive 2002/92/EC should not neglect this profile.

Finally, it was revealed that the Directive 2002/92/EC contains a definition of mediation (reinsurance and insurance), but establishes rules governing intermediaries who engaged in these activities. Therefore, each Member State is allowed to distinguish the abovementioned activities reserving their performance to different categories of intermediaries: insurance and reinsurance.

The consequence of this distinction will be the application of different rules for access and business conduct; while, regulatory arbitrage or interpretative uncertainty could be possible risks, if such rules were distinct without any justification. Where a global policy is being issued providing cover over a global group of companies, in fact, fronted policies may be issued locally for each local affiliated company. In such cases the undertaking that provides the cover is the

insurer who issues the global policy and, at the same time, that undertaking is also the reinsurer of the respective fronted local policies. However, in reality, the reinsurer is the actual first insurer since the fronted policy is merely issued for regulatory purposes. Since the reinsurance intermediary acts as a first insurance broker, the question is as follows: should the intermediary be subject to the same principles that apply to first insurance broker?

I don't think that the answer to this question is provided by the Directive 2002/92/EC; while, the finding that the broker is acting in a dual capacity<sup>30</sup>, is not an optimal solution for those member States that have separate categories of intermediaries in accordance with such a possibility offered by the Directive. Nevertheless, a response should be provided by the EU regulation, if it aspires to build an efficient Single Market.

Ultimately it appears that the answers to several questions concerning reinsurance intermediaries are not the present but (may be) the future of this Directive.

## SUMMARY

*The current rules on reinsurance intermediaries in the Directive 2002/92/EC does not seem likely to counteract the risks that the essay has revealed.*

*In addition to solvency risk, a concern is emerging about the effects that can arise on insurance companies and, above all, on insured by unfair practices in the reinsurance market; while the "dual capacity" that sometimes characterizes the reinsurance intermediary in its activity could encourage regulatory arbitrage, or create uncertainty on the rules applicable.*

*It may be that the rules of each Member State on reinsurance intermediaries are able to counteract these phenomena. However, the objective of creating an effective Single Market is frustrated by the absence of a minimum level of harmonization.*

*Therefore the essay has attempted to provide various proposals that - hopefully - be usefully considered for the forthcoming launch of the procedure of amending the Directive 2002/92/EC.*

<sup>29</sup> Regulation (EC) No 358/2003, in fact, will expire on 31 March 2010. Consultation launched by the EU Commission and replies are available at [http://ec.europa.eu/competition/sectors/financial\\_services/insurance.html](http://ec.europa.eu/competition/sectors/financial_services/insurance.html)

<sup>30</sup> See. C. HENLEY, *The Law of Insurance Broking*, London, Sweet & Maxwell, 2004, p. 471.