

Market definition

Introduction

1. This appendix sets out the relevant economic market that may be affected by the merger of HAL and CBSPC. It discusses both the product dimension and the geographic dimension of the relevant economic market.

Background: activities of the merging parties

2. HAL provides advice and support to individuals and corporate entities that supply capital to the Lloyd's market. Its core business (that provides 90 per cent of its total revenue) is the provision of both general and bespoke advice and support to active unaligned¹ individual members (both unlimited liability members (names) and members who participate through limited liability vehicles such as NameCos, SLPs, and (from 2007) LLPs). These services include syndicate analysis, research and performance monitoring, as well as individual client care, including risk assessment and related back-office activities such as placing members' capital on syndicates and dealing with managing agents on their behalf. HAL also provides underwriting research for a small number of corporate members,² as well as administrative services to a small number of aligned corporate members³ (ie managing agents whose syndicates are 100 per cent supported by their own capital).
3. Before the merger, CBSPC also provided advice and support to individual and corporate members that supply capital to the Lloyd's market. 89 per cent⁴ of the individual members represented by CBSPC underwrote on an unlimited liability basis.

Relevant product market

4. It was put to us that as both HAL and CBSPC were active in the market for the supply of capital to the Lloyd's market, the merger would lead to an increase of concentration in this area. However, it is the members who actually supply capital to the Lloyd's market, not the members' agents. The members' agents are intermediaries acting on behalf of the members. This does not make them suppliers of capital themselves. Thus, members' agents cannot be considered suppliers of capital to the Lloyd's market.⁵ For the purposes of the present case, therefore, it is not necessary to discuss the supply of capital to the Lloyd's market further.

¹Unaligned members are individual members and some corporate members that have no ownership links with managing agents and usually participate on several syndicates.

²HAL provides underwriting research to Atrium and Aegis. In addition, HAL provides advice on syndicate participation to Cathedral for approximately 30 per cent of its capacity. These contracts account for approximately 2 per cent of HAL's fee income.

³HAL provides administrative services to Heritage, Illium, and Cathedral. As these entities have been able to negotiate a reduced fee for the services provided by HAL, their fees amount to approximately 5 per cent of HAL's fee income.

⁴By number.

⁵HAL notes that the sourcing capital from investors and providing it to syndicates bears comparison with the business of managing agents raising capital from corporate entities (or the financial markets) and supplying such capital to syndicates. This does not change the conclusion that members' agents do not actually supply the capital themselves but are merely intermediaries.

5. It is important to distinguish between services provided to active and inactive members of Lloyd's. In addition to the provision of advice and support to active Lloyd's members, all members' agents provide administrative services for members who have ceased underwriting, but who must remain members of Lloyd's until all their liabilities have been calculated and reinsured to close, ie inactive members. These inactive members pay a one-off winding-up fee to their supplier of members' agency services.⁶ Given that administrative services to inactive members only account for a small part of members' agents' revenue and are not part of their core business, for the purposes of the present inquiry it is not necessary to discuss these services further.
6. Our analysis therefore focuses on the provision of advice and support to active individual Lloyd's members, which we will from hereon refer to as members' agency services.

Analytical framework

7. The generally accepted conceptual approach to market definition, used in many jurisdictions, is the hypothetical monopolist test. In applying this test, we consider whether a hypothetical monopolist of a certain product or set of products, which might constitute a market, could profitably impose a SSNIP. In particular, two key responses to such a price rise are analysed:
 - (a) Demand-side substitution: the effect of customers switching to substitute products following an increase in price.
 - (b) Supply-side substitution: the effect of suppliers commencing or increasing the supply of the products whose price rises.
8. We consider whether a hypothetical monopolist of members' agency services could profitably raise its prices (ie fees and/or profit commission) by 5 per cent, evaluating the potential constraints imposed on members' agency services by demand and supply substitution in the form of advisory services from other advisers and other investment options inside and outside the Lloyd's market. If it were found that a hypothetical monopolist of members' agency services could profitably raise its charges by 5 per cent because only few individual members (or none) would switch to other advisers or reduce or stop underwriting at Lloyd's in response, we would conclude that there are insufficient constraints on members' agents and, consequently, that the relevant market is narrow, constituting members' agency services alone.

Non-price competition and service quality

9. The hypothetical monopolist test also applies to non-price competition, eg competition in service quality. A small but significant non-transitory decrease in service quality for a given price level (ie keeping price constant) is equivalent to a SSNIP for a given level of service quality (ie keeping service quality constant). In both cases, service quality would essentially become more expensive. A decrease in service quality may be profitable for suppliers if it decreases their costs. For a given price this means the difference between price and costs, ie profit, increases. The same would happen if price was increased directly.

⁶Inactive members can choose to have their affairs handled by LMAS.

10. In the case of members' agency services, if individual members were faced with a decrease in service levels but had to keep paying the same price, they would be buying less quality for their money. In other words, quality would have become more expensive. To purchase their old, higher level of service, they would have to pay more. This would also be the case if the members' agents simply raised the price of their services.

Assessment

11. Broadly speaking, there are two potential sources of demand- and supply-side substitution in response to a hypothetical price increase by members' agents:
 - (a) similar services provided by other agents (both supply- and demand-side substitution); and
 - (b) the possibility that individual members would stop or reduce underwriting at Lloyd's and switch to other investment options inside or outside the Lloyd's market (demand-side substitution).

Potential constraint I: similar services provided by other agents

12. Hampden suggested that there was an increasing number of intermediaries who offered similar syndicate advice services as those provided by members' agents. Examples are Newton Follis, Patrick Moore and Artannes Capital. Similarly, Hampden suggested that financial analysts such as Moody's, AM Best, Standard & Poor's, and Fitch could act as a source of information. We note that information and advice may be available from independent financial advisers, accountants and lawyers.
13. We will briefly describe the services that each of the mentioned third parties provides.
 - *Newton Follis*: Newton Follis is a small advisory agency with five staff that provides advisory services to existing and new members of Lloyd's underwriting on a traditional basis either with unlimited or with limited liability. Services include an assessment of the insurance market in total and by sector, determining the appropriate level of underwriting to be undertaken given the individual client's financial circumstances and risk tolerance, and devising an underwriting portfolio for the following year of account. Newton Follis told us that it did not consider itself to be in competition with members' agents as it did not provide the full range of members' agency services (ie including back-office activities) and all its clients were currently required to retain a members' agent. Newton Follis has no intention of establishing a fully fledged members' agency, because of the declining number of individual members and the nature of the Agency Agreement (which it thinks is outdated and causes too many conflicts of interest).
 - *Patrick Moore*: Patrick Moore is a member of Lloyd's who currently advises 14 other individual members in Australia. Services include syndicate analysis, research of the insurance market, reviewing recommendations by members' agents and advice on syndicate participation. Patrick Moore told us that he did not consider himself to be in competition with members' agents because he and all his clients were required to retain a members' agent. Patrick Moore has no intention of entering the supply of members' agency services because of risk considerations.

- *Artannes Capital*: Artannes Capital is a company specializing in sourcing new investment strategies to hedge funds that are seeking to diversify or increase their investments to non-correlated market opportunities. Artannes Capital has recently had its FSA permissions extended to allow it to advise on Lloyd's investments (June 2006).
 - *Financial analysts*: Financial analysts such as Moody's, AM Best, Standard & Poor's, and Fitch are a source for credit ratings, general research and risk analysis. AM Best specializes in financial analyses of the insurance market. In contrast to Newton Follis and Patrick Moore, who also offer bespoke advice regarding underwriting on particular syndicates, these financial analysts offer only general information.
14. Currently, according to the customer survey conducted by Harris Interactive, 44 per cent of active individual members also receive some form of advice or information from other advisers and analysts such as the ones described above or from representative bodies such as the ALM and the HPG. Most of these individual members obtain general information from these other advisers, analysts and/or representative bodies in the form of newsletters, information mailings and general monitoring results, while 26 per cent obtain some form of advice regarding syndicate participation.

Potential for supply-side substitution

15. Hampden argues that these independent advisers and financial analysts are realistic alternatives for many of the services supplied by members' agents to individual Lloyd's members. As such, they would constrain HAL's members' agency charges and any potential decreases in service quality following the merger, since they would be able to provide an alternative source of services to which members could switch in response to a price increase.
16. In order for these advisers and analysts to be able to supply members' agency services, they would require authorization from the FSA and approval from Lloyd's. Newton Follis and Patrick Moore would need to add the facility to provide administrative services for members, which they do not currently do. The other companies discussed above would need to set up both administrative and advisory services, in addition to the information services that they currently provide. It should be noted that barriers to entry (or supply substitution) in this market are high.⁷ Other advisers and financial analysts therefore are unlikely to be able promptly to supply members' agency services in the event of a 5 per cent increase in existing members' agents' charges.

Potential for demand-side substitution

17. The main difference between members' agents and other advisers is that these other advisers do not provide the back-office activities that are typically undertaken by members' agents. These include dealing with managing agents on behalf of members and more generally carrying out the administrative tasks that are associated with underwriting at Lloyd's. Even if individual members wanted to switch to other advisers such as the ones described above, they would not be able to do so, because of Lloyd's requirement for members to retain a members' agent, as specified in Section 24 of the Lloyd's Membership Byelaw. Whilst in theory it is possible to

⁷See Appendix G.

be granted a dispensation from this requirement, Lloyd's has told us that this dispensation was not available to individual members with unlimited liability, and the evidence shows that no individual member has ever applied for such a dispensation.

18. Therefore, individual members would not be able to switch to alternative advisers if faced with a 5 per cent increase in members' agency charges or an equivalent decrease in service quality, and so other advisers and analysts are not included in the relevant product market definition.

Potential constraint II: stop or reduce underwriting at Lloyd's

19. As indicated in paragraph 11, a second potential constraint on members' agents is the possibility that individual members would stop or reduce underwriting at Lloyd's in favour of other investment options inside or outside the Lloyd's market. If a 5 per cent increase in members' agents charges or an equivalent decrease in service levels were to render underwriting at Lloyd's less attractive compared with other investment options, individual members might stop or reduce underwriting at Lloyd's and as a consequence demand for members' agency services would decrease.

Potential alternative investments

20. Potential alternatives to underwriting at Lloyd's (via a members' agent) include the following:
 - (a) *Investment in a Lloyd's listed vehicle:* Lloyd's listed vehicles are public listed insurance companies that own corporate members which underwrite on syndicates managed by a managing agent that is also part of the same group. There are 13 listed groups.⁸
 - (b) *Collective investment schemes:* Collective investment schemes are arrangements that enable a number of investors to pool their assets and have these professionally managed by an independent manager.
 - (c) *Group conversion vehicles:* Group conversion vehicles are corporate entities comparable with NameCos, SLPs, and LLPs, formed by members' agents (CBSPC) or other Lloyd's groups (currently only Talisman) to allow individual members to convert from unlimited liability individual membership of Lloyd's to shareholders in a limited liability corporate member of Lloyd's. According to Hampden, conversion vehicles aim to spread their investment over a broad number of syndicates.
 - (d) *Investing in the insurance sector:* The most common ways of investing in the insurance sector are to purchase shares of large insurance companies that are active in various insurance markets in the world or to participate in collective investment schemes that invest in these insurance markets.
 - (e) *Investing outside the insurance sector:* There are many investment options in the wider financial sector, including purchasing shares in listed companies, participating in investment funds or investing in bonds or real estate.

⁸Including Atrium, Beazley, Chaucer, and Hiscox.

Unique features of underwriting at Lloyd's

21. Underwriting at Lloyd's has a number of specific features, however, not all of which may be replicated by the above investment options. These specific features may affect members' incentives to stop or reduce underwriting at Lloyd's and switch to other investment options. They include:
 - (a) the ability to participate personally in insurance underwriting;
 - (b) tax benefits of underwriting at Lloyd's; and
 - (c) the double use of capital.
22. *The ability to participate personally in insurance underwriting:* Underwriting at Lloyd's allows individual members to make personal decisions regarding syndicate participation. According to the customer survey carried out by Harris Interactive, 81 per cent of active individual members considered the ability to participate personally in insurance underwriting to be an important reason for choosing to underwrite at Lloyd's. Hampden notes that the ability to invest in Lloyd's underwriting may be replicated to a large extent by investing in one of the 13 listed Lloyd's vehicles. However, this does not take account of the importance that many individual members place on the ability to decide personally which syndicates to participate in and how much capital to allocate to each syndicate.
23. *Tax benefits of underwriting at Lloyd's:* The profits and losses from underwriting at Lloyd's are considered as trading profits and losses for tax purposes (as compared with capital gains and losses from investment). The benefit of this is that trading losses can be offset against any source of income during that same year, carried back one year against any source of income during that earlier year, or carried forward against profits from that trade in future years. Capital losses can only be offset against capital gains in a given year, or alternatively, be carried forward against capital gains in later years. This benefit applies to all individual members of Lloyd's.⁹ There may also be certain inheritance tax advantages associated with underwriting at Lloyd's. Specifically, the value of assets provided by individual Lloyd's members as security is eligible for Business Property Relief (BPR)¹⁰ at 100 per cent, but in value only up to the amount required by Lloyd's. According to the customer survey carried out by Harris Interactive, 84 per cent of active individual members considered the relative tax efficient use of their available capital to be an important reason for choosing to underwrite at Lloyd's.
24. *The double use of capital:* Underwriting at Lloyd's allows investors to make double use of their assets. Underwriting at Lloyd's can be capitalized with a bank guarantee secured on a portion of a client's existing assets, such as existing equity portfolios, buy-to-let property or unit trusts. This means the investor retains an income stream on the underlying assets while also benefiting from insurance returns. The downside

⁹More specifically, for unlimited liability members, all profits from underwriting business are taxed as profits from trade, including income from funds at Lloyd's (ie the risk capital provided by members that is held in a trust by Lloyd's), but excluding gains/losses on disposal of assets forming the funds at Lloyd's (which are taxed as capital gains). For corporate members and NameCos, all profits from underwriting, including gains/losses on disposal of assets forming the funds at Lloyd's, are taxed as profits from trade.

¹⁰BPR applies to the value of an estate or transfer of value that is attributable to the value of 'relevant business property', which includes property consisting of a business or an interest in a business. For inheritance tax purposes, an 'interest in a business' is regarded as applying to an individual's interest in a partnership, including both an SLP and an LLP. The inheritance tax position is a little different for NameCos. Where the estate of an individual includes the value of assets they provide as security for a NameCo's funds at Lloyd's, those assets are not part of a business that they own or in which they have an interest. Thus they are not eligible for BPR; however, the impact of the funds at Lloyd's arrangements is taken into account when valuing the underlying assets in a deceased's estate for inheritance tax purposes.

is that members also risk losing their entire underwriting capital, which may be more than their funds at Lloyd's.¹¹ Nevertheless, according to the customer survey carried out by Harris Interactive, 95 per cent of the respondents considered the relatively profitable use of their available financial capital to be an important reason for choosing to underwrite at Lloyd's, two-thirds of which considered it to be a very important reason.

Ability to stop or reduce underwriting at Lloyd's

25. If active individual members wish to reduce their underwriting at Lloyd's in response to a 5 per cent increase in members' agency charges or an equivalent decrease in service levels, they can sell part of their right to participate on a syndicate for a subsequent year of account in a capacity auction. Since 2001 there have been three auctions in September of each year. (In 2006 there will be a fourth auction, in December.)
26. Stopping underwriting at Lloyd's completely is a lengthier process. According to the Lloyd's Membership Byelaw, unless the Council otherwise directs, membership of Lloyd's terminates at midnight on 31 December following the later of (i) the date on which that member submitted an application to resign from Lloyd's and (ii) the date as from which the last year of account of every syndicate of which that member was a member (if any) was closed by reinsurance to close.¹²
27. Normally, syndicates seek to reinsure to close within the three-year account. However, sometimes it may take longer for a syndicate to find a reinsurer so it can close its accounts. As long as any of the syndicates on which a member participated remains open, that member is unable to resign from Lloyd's. Until individual members can resign from Lloyd's, they cannot access their funds at Lloyd's to use their capital for other forms of investment.
28. Therefore, underwriting at Lloyd's is a less flexible form of investment than, for example, investing in equities.¹³

Incentives to stop or reduce underwriting at Lloyd's

29. When comparing underwriting at Lloyd's with other investment options and determining individual members' incentives to stop or reduce underwriting at Lloyd's, we must consider the total cost of underwriting at Lloyd's. In addition to members' agency charges, the total costs of underwriting at Lloyd's (via a members' agent) include managing agents' charges (including 20 per cent profit commission) and Lloyd's charges (Central Fund charge plus administration and subscription charges). Members' agents' charges make up approximately 10 to 15 per cent¹⁴ of active individual members' total annual costs of underwriting at Lloyd's. This implies that if members' agency charges were to increase by 5 per cent, the overall costs of underwriting at Lloyd's for active individual members would increase by less than 1 per cent.

¹¹Moreover, if underwriting on an unlimited liability basis, individual members risk losing all of their assets.

¹²See the Lloyd's membership Byelaw, Part H, paragraph 45.

¹³However, it should be noted that members' agency charges cannot be changed overnight either. To change its fee structure and bring about an increase, HAL would have to give notice by the end of April to all members, cancelling their agency agreement at the end of that year. HAL would then have to make a proposal to Lloyd's to increase its fees for the following year of account. Members would then have to decide if they wanted to reduce or stop underwriting at Lloyd's in response to the increase in charges before they would have to sign up for their syndicate lists for the following year's underwriting in November.

¹⁴According to HAL, based on 6.70 per cent profit (which is set to reflect HAL's out-performance compared with Lloyd's overall target of 4.70 per cent a year). Note that these are annual charges only and exclude one-off (setup) charges.

30. Given that (a) members' agency charges are only part of the total cost of underwriting at Lloyd's, (b) there are specific benefits of underwriting at Lloyd's and (c) the exit process can be lengthy, we do not expect that a 5 per cent increase in members' agency charges would provide individual members with significant incentives to stop or reduce underwriting at Lloyd's.
31. The customer survey carried out by Harris Interactive asked individual members what they would do if their members' agent increased its fees by 10 per cent next year (eg from £5,000 to £5,500) and if they were not able to negotiate on this or any other aspect of commission or charges). 10 per cent of respondents indicated they would stop or reduce their underwriting capacity.¹⁵ Hampden believed this showed that the potential to substitute to other forms of investment exerted a significant constraint upon the prices of members' agency services, and hence that such alternative investments would fall within the same relevant product market. However, we do not agree with this analysis, since:
- (a) The results imply that a 10 per cent price increase would be met by a reduction in demand of *less than* 10 per cent, given that those who said they would *reduce* their underwriting capacity would not fully withdraw their demand—in contrast to those who said they would stop underwriting altogether.
- (b) When asked about their reactions to price increases, respondents tend to predict reactions that are more 'virtuous' than their actual reactions. That is, survey responses tend to overstate the expected extent of switching in response to a price increase. As such, any indications of switching in response to a hypothetical price increase should be viewed as an upper boundary to the true extent of customers' actual behaviour following an observed price increase.
32. A further 8 per cent of respondents indicated that they would *consider* stopping or reducing underwriting at Lloyd's.^{16,17} Some members (16 per cent) would simply accept the fee increase. Others would complain (14 per cent), ask for a reason (14 per cent), compare with other agents (10 per cent) or explore alternatives (4 per cent). None of these actions necessarily reflect a reduction in demand or tell us anything about members' price-sensitivity. Hampden notes that, notwithstanding the above, the reactions of customers would be taken into account by a commercial organization that was proposing to raise its fees.

Assessment

33. Although there are various alternative investment options both inside and outside the Lloyd's market, it does not appear to us that a 5 per cent increase in members' agency charges (or equivalent decrease in service levels) would make underwriting at Lloyd's sufficiently unattractive compared with other investment options to generate a substantial amount of switching to such alternative investments. Invest-

¹⁵4 per cent of respondents indicated that they would reduce their underwriting capacity and 6 per cent of respondents indicated that they would stop underwriting at Lloyd's in response to a 10 per cent increase in members' agents' charges. There is marginal overlap because the questionnaire allowed multiple responses; only a very small percentage answered that they would both stop and reduce underwriting. 21 per cent responded that they were not sure what they would do.

¹⁶The question allowed for multiple answers. In total, 10 per cent of the respondents answered that they would consider stopping or reducing underwriting at Lloyd's. Some of these respondents *also* answered that they would actually stop or reduce underwriting. In addition to those respondents who responded they would actually stop or reduce underwriting (ie, including those who also said they would consider doing so), a further 8 per cent of respondents indicated that they would consider stopping or reducing underwriting at Lloyd's.

¹⁷It should be stressed that considerations are not the same as concrete actions. The proportion of members who answered they would *consider* stopping or reducing underwriting in response to a hypothetical price increase can therefore not be included in the reduction in demand (made up by the proportion of members that said they would actually stop or reduce underwriting) that would take place in response to the hypothetical price increase.

ment at Lloyd's has a variety of features which cannot easily be replicated by other types of investments. Consequently, we would expect a hypothetical monopolist of members' agency services to be able to raise its charges (or decrease service levels) profitably by 5 per cent. This implies that other investment options do not pose a sufficient constraint on members' agents for them to be included in the relevant product market definition.

Relevant geographic market

34. In general, the relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas. Essentially, the geographic boundaries of the relevant market are determined by the extent to which customers can readily switch between substitute products, or suppliers can readily switch their facilities between the supply of alternative products.
35. A hypothetical monopolist approach may help to determine whether the relevant market is international, national, regional or local in scope. In considering the geographic market, the test looks at whether a SSNIP of the products in the relevant product market in a narrowly defined region would be profitable. If a such a price increase would not be profitable, for instance because customers would switch to products in neighbouring areas, then the relevant product market would be widened to include these areas and the analytical process would be repeated. The relevant market is defined as the smallest area in which a hypothetical monopolist could sustain a SSNIP profitably.¹⁸ The geographic scope thus merely describes the area in which all of the potential suppliers are active in each of the potential product markets.
36. In the case of members' agency services, having defined the relatively narrow product market for the supply of members' agency services to active individual members of Lloyd's, the only provider members could switch to is Argenta—irrespective of the geographic scope in which members' agents operate. The geographic market could be considered as only the UK, since this is the area where HAL and Argenta are located, or alternatively could be considered to be wider, since HAL and Argenta serve customers in other countries. However, we would expect the assessment of the competitive effects of the merger to be the same under either geographic market definition.

Conclusion

37. On the basis of the evidence discussed throughout this appendix, we conclude that the supply of members' agency services to active individual Lloyd's members constitutes a separate relevant product market. The assessment of the competitive effects of the acquisition is not sensitive to the question of whether the relevant geographic market is wider than the UK.

¹⁸See *CC2: Merger References: Competition Commission Guidelines* (June 2003).