OFFICE OF FAIR TRADING

Proposed acquisition by Unum Limited of the employee benefits business of Swiss Life (UK) plc

The OFT's Decision on reference under section 33 given on 31 October 2003

PARTIES

Unum Limited (trading as **UnumProvident**) is a specialist provider of income protection, critical illness and life insurance products and related services. In the year ending 31 December 2002, UnumProvident's reported UK turnover was £269m on gross year-end assets of £1,046m.

Swiss Life (UK) Employee Benefits sells life, income protection and critical illness insurance products. Its parent company **Swiss Life (UK) plc** specialises in insurance-based income protection products to both employers and individuals. The proposed transaction only covers the Swiss Life (UK) Employee Benefits business. The UK turnover of the Swiss Life Employee Benefits business was approximately £211m in the year ending 31 December 2002.

TRANSACTION

On 14 August 2003 UnumProvident and Swiss Life (UK) entered into agreements under which UnumProvident has agreed to acquire:

a) the in-force policies, related reserves and claims of Swiss Life (UK)'s group income protection business (and renewal rights); and

b) the renewal rights to the Swiss Life (UK)'s group critical illness and group life businesses.

The transaction was notified as an informal submission on 12 September 2003. The administrative deadline for a decision is 31 October 2003.

JURISDICTION

As a result of this transaction, UnumProvident and Swiss Life's Employee Benefits business will cease to be distinct. The UK turnover of Swiss Life's Employee Benefits exceeds £70 million, so the turnover test in section 23(1)(b) of the Enterprise Act 2002 (the Act) is satisfied. A relevant merger situation is likely to be created.

RELEVANT MARKET

Product market

The parties overlap in the supply of Group Life (GL), Group Critical Illness (GCI) and Group Income Protection (GIP) insurance products. These are collectively referred to as Group Risk products.

Group Risk insurance is taken out by employers on a company wide (or group) basis as part of a broader incentive package to recruit and retain staff.

- GL insurance involves the payment of a lump sum in the event of death of an employee or dependant. The GL sector is the largest area both in terms of value and number of lives covered. GL accounted for £749 million in premiums spread across more than 7 million lives in the UK in 2002 (see note1).

- GCI pays out a lump sum benefit if the employee contracts one of the critical illnesses covered by the policy. This payment is designed to cover medical treatment and other costs such as adaptation of the employee's home, lifestyle or travelling arrangements. GCI is relatively small, accounting for only £16 million in premiums and 135,000 lives covered in 2002 (see note 1).

- GIP pays a monthly income while the insured employee is unable to work due to illness or injury. These payments will generally continue until the employee either returns to work or reaches retirement. The provision of GIP may also involve the supply of rehabilitation services to get the employee back to work sooner. In 2002, GIP accounted for £507 million in premiums and 1.8 million lives insured (see note 1).

Three main possible frames of reference for assessing the competitive effects of the transaction need consideration: (1) Group Risk products as part of the wider employee benefits sector; (2) the Group Risk sector as a distinct segment; or (3) GL, GCI and GIP as separate segments.

It was submitted by the parties that the three categories of Group Risk policies they offer form part of a wider range of employee benefits available to employers who wish to provide incentives to their workforce. In addition to GIP, GCI and GL, the employee benefits market was said to include private medical insurance, group personal accident insurance, group dental cover and group health cash plans.

On the demand side, GCI, GL and GIP policies do not appear to be good substitutes for each other. Customers indicated that, in general, they would not consider either ending Group Risk provision or switching to an alternative employee benefit given a small but not significant increase in premiums. They also suggested that individual policies are not an effective substitute for group policies due to the difference in cost and the administrative burden of managing individual policies.

On the supply side, there is evidence that supply-side switching between the Group Risk segments is asymmetric. While it appears relatively easy to switch from the supply of GIP

and GCI into GL, the reverse may be more difficult. GIP policies (and, to a lesser extent, GCI) are significantly more complex than GL and third party responses highlighted that some technical, actuarial, underwriting and claims handling skills in these three segments were often quite different.

For the purposes of this assessment, we therefore start by considering the competitive effect of the transaction within narrow frames of reference: that is, GCI, GL and GIP as distinct segments within the Group Risk sector (recognising that these segments may not comprise relevant economic markets). The existing and potential constraints within these segments and the wider Group Risk sector are examined in more detail below.

Geographic market

Cross-border trade is not a feature of the Group Risk sector as there are regulatory barriers to international trade and insurers from abroad need to gain clearance from the FSA to operate in the UK. In addition, while most of the insurers active in Group Risk are multinationals, customers and intermediaries generally deal with a national subsidiary or regional office. The relevant geographic frame of reference would therefore appear to be no wider than the UK.

COMPETITIVE ASSESSMENT

Shares of supply

Table One below provides details of the share of supply for each of the GL, GCI and GIP segments. For completeness, the table also includes figures for the combined Group Risk sector.

Table One: UK share of supply by percentage of Gross Premium Income in Group Life, Group Critical Illness and Group Income Protection

	GL	**GCI**	**GIP**	**Combined GL, GCI,GIP**
UnumProvident	[15-20]	[10-15]	[40-45]	[25-30]
Swiss Life	[15-20]	[50-55]	[15-20]	[15-20]
Combined	***[30-40]***	***[60-70]***	***[55-65]***	***[40-50]***
Others:				
[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]
Total Value (£m)	*749*	*16.2*	*507*	*1272.2*

Source: GE Frankona survey 2003
Notes: UnumProvident figure includes Sun Life of Canada business acquired in February 2003.
(see note 2)

Following the merger, supply of GL, GCI and GIP will be very concentrated, with UnumProvident becoming the largest supplier in all three segments and accounting for more

than 50 per cent of the share of supply for GIP and GCI. The majority of the remaining competitors hold relatively small shares, with only Canada Life's GL business offering an equivalent scale to UnumProvident or Swiss Life.

The parties maintain that these shares overstate their competitive position, in part because it is only GIP where the in-force policies are being transferred from Swiss Life to UnumProvident. Moreover, they argue that churn (see note 4) rates estimated to be around [ ]-[ ] (see note 5) mean that they will not retain the entire Swiss Life portfolio due to lapses at renewal. Table Two shows their estimates for shares amended for expected policy lapses. Even the amended shares of supply estimates show high concentration, and UnumProvident will still be the leading player in the GIP and GCI segments post merger.

Table Two: Percentage share of supply including expected policy lapses

	GL	**GCI**	**GIP**	**Combined**
UnumProvident	[15-20]	[10-15]	[40-45]	[25-30]
Swiss Life	[5-10]	[30-35]	[10-15]	[5-10]
Combined	***[20-30]***	***[40-50]***	***[50-60]***	***[30-40]***

Source: GE Frankona and Unum Business Plan 2003
Notes: UnumProvident figure includes Sun Life of Canada business acquired February 2003
(see note 3)

In any event, the parties submitted that examining shares of supply on this narrow basis did not adequately reflect the extent of existing rivalry within the Group Risk sector. To investigate this proposition further, actual bidding data on recently negotiated contracts was examined.

Existing competition

The majority of Group Risk contracts are negotiated by intermediaries on behalf of customers. For both renewals and new contracts, a competitive tender is held, with the intermediary inviting between 6 to 12 bids from various providers in the sector. Approximately 600 contracts [a month] (see note 6) are re-broked in this way every year. Bidding data in respect of a sample of these tender processes was supplied by both the parties and third parties during the course of the OFT's investigation.

The parties put forward two arguments in respect of the data they submitted. First, a large number of sophisticated and well-resourced bidders (including AIG, Scottish Equitable, Sun Life, Legal and General, Generali, Friends Provident, Canada Life and Norwich Union) are regularly invited to quote for contracts (both large and small). Second, bidders with small current shares of supply in the relevant segments are not “small” companies, and they bid for and win large contracts.

Examining the first point, the parties presented bidding data which showed that for significant contracts (valued at between £450,000 and £2 million annual premia) a high number of smaller Group Risk providers were generally invited to submit quotes alongside those of the larger players. Evidence provided by third parties also indicated that around 6 to 10 providers were generally invited to bid for a contract. However, intermediaries

indicated that of those invited to bid around half responded for smaller contracts, but for larger contracts often only two or three quotes were actually received.

On the second point, the parties submitted information showing large contracts which had recently been lost to other insurers (including some with relatively small positions in GL, GCI, or GIP). While this information did provide evidence of smaller players winning contracts for which UnumProvident had previously been the holding insurer[1], the contracts appeared to be much smaller in size than the significant contracts discussed above. With the exception of one contract valued at £250,000, the bids won by smaller Group Risk players appeared to be restricted to contracts with annual premia between £100,000 and £170,000. It should also be noted that the bidding information supplied by the parties[2] related to only nine bids over a six month period, which represents a very small sample relative to the total number of bids submitted each year ([ ]) (see note 6).

The parties also submitted that significant contracts (which generally cover more than 300 lives) represented only a small proportion [less than 10 per cent] (see note 3) of the overall number of schemes in the Group Risk sector and that many competitors with a small share of supply had larger average GIP schemes sizes than that of UnumProvident. Table Three below shows the average GIP scheme sizes submitted by the parties.

Table Three: Average GIP scheme sizes

Supplier	**2002 (£)**	**2001 (£)**	**2000 (£)**
UnumProvident	[22,000 – 23,000]	[22,000 – 23,000]	[21,000 – 22,000]
[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]
Industry average	*23,180*	*21,060*	*18,491*

Source: GE Frankona Surveys
(see note 2)

Concerns over smaller players' ability to bid for large contracts were also borne out by intermediaries. A number of third parties raised concerns that, with respect to larger risks the pool of providers able to bid for these contracts was generally limited to the three larger players – Swiss Life, UnumProvident and Canada Life. Bidding information supplied by intermediaries suggested that – for contracts with premiums in excess of £100,000 – UnumProvident, Swiss Life and Canada Life consistently featured among the successful bidders, with the smaller players only occasionally being awarded large contracts.

On balance, while it appears that smaller Group Risk providers may act as some form of constraint on the merged entity with respect to smaller contracts, there is insufficient evidence to show that this is also likely to be the case for larger contracts. On this basis, post-merger the number of major bidders for large contracts would be reduced from three to two.

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[1] Excepting one case where a smaller player won a contract while competing against UnumProvident.
[2] In respect of large contracts won by providers with smaller shares of supply.

Potential competition

In addition to the presence of existing rivals in the three segments, the parties submitted that their future competitive behaviour would also be constrained by expansion by existing Group Risk providers, and/or new entry by other insurers not presently active in the Group Risk sector.

The parties have argued that the majority of Group Risk providers with small shares, are not in fact small companies, but are generally part of much larger UK or international insurers, the size of which significantly exceeds that of UnumProvident. Evidence was provided to demonstrate that, within the wider UK insurance sector, UnumProvident was ranked 50th based on total net premiums and 65th on total net assets. These 'smaller' players were considered to have the resources internally (or readily available from third parties) to rapidly expand capacity in the Group Risk sector in response to a price increase by the merged entity.

This argument would appear to have some force, given that the smaller players in the GL, GCI and GIP segments are companies such as Norwich Union, Legal and General, AIG and Generali. However, barriers to entry and expansion may exist.

- First, there are said to be advantages associated with being the holding insurer. It appears that the holding insurer is usually offered the chance to be last bidder (thereby being given an opportunity to match the lowest bid) and, because of the information asymmetries and administrative difficulties in switching insurers, may have a distinct advantage over its rivals.

- Second, access to and reliance on re-insurance may hinder attempts to expand in the sector. Smaller players are particularly reliant upon re-insurance in premium setting and to manage portfolio risk. For small players and new entrants re-insurance is more difficult to obtain on favourable terms. Furthermore, re-insurance capacity is limited and re-insurers often place restrictions on the types of risks they will support.

- Third, reputation is considered to have a significant influence on customer behaviour. Intermediaries and customers often see reputation as assurance that the insurer has sufficient capital and that service levels will be adequate.

In response to the first of these points, the parties submitted that while for some contracts this was the case, it was not standard practice for all intermediaries to give the holding insurer the chance to be the last bidder. They also argued that the holding insurer held no advantage in the bidding process as all bidders were provided with the same information, including census data and claims, which ensured a 'level playing field'. However, renewal rights would appear to have some value since they do form a part – albeit a relatively small one – of the proposed transaction. Furthermore the parties' own business plan estimated that only [ ] and [ ] (see note 5) of the Swiss Life GL and GCI books, respectively, would be lost on renewal.

In response to the second point, the parties submitted that it was incorrect to assume that small players would find it more difficult to obtain favourable re-insurance terms: as these

smaller players are part of larger insurers they are able to use their scale to negotiate favourable terms for re-insurance across their portfolio. For example, [ ] (see note 5) was identified as a well-established company that has been able to obtain more favourable re-insurance terms than that of UnumProvident.

With regard to reputational barriers to entry and expansion, the parties argued that as part of a larger insurer, a new entrant would benefit from strong brand awareness and reputation across the wider insurance market which could easily be carried over into the Group Risk sector. However, comments from intermediaries generally supported the view that reputation within the Group Risk sector was an important consideration when choosing a provider.

More generally, the parties argued that the only reason that these large insurers held small shares of supply in the Group Risk segments at present is due to a decision not to focus on the sector. GCI, GL and GIP products generally represented a very small part of their overall business and are therefore not given the 'management focus' to be developed. The parties asserted that if these providers chose to focus on these products, they could do so very easily. [ ] (see note 5), HSBC was used to demonstrate how a supplier could rapidly build a large market share over a period of 3 to 4 years. (Although it must be noted that HSBC's expansion was in relation to the individual GIP, GCI and GL (see note 7) segments and it is uncertain whether Group and Individual Risk sectors are directly comparable.)

The parties' arguments appear to have some force, but it is difficult to reconcile these arguments with an assessment of the history of expansion in the GL, GCI, and GIP segments. For example, as an experienced and highly resourced recent entrant into the Group Risk sector, BUPA would appear to be well placed to win share in the Group Risk sector, particularly given its extensive medical expertise and experience in individual insurance. However, three years after entering the sector, BUPA has only managed to gain a share of overall Group Risk products of around [less than 2 per cent] (see note 9). Furthermore, two competitors stated that following a change in strategy they had decided to focus on the Group Risk sector. Despite both being large, well resourced organisations, 2 to 3 years after choosing actively to pursue this strategy they are both still relatively minor players in the sector.

Overall, it would appear that barriers to expansion in the Group Risk sector might well be significant. While the parties' arguments that entry and expansion is relatively easy would appear to be a credible possibility, the actual experience of competitors in the sector suggests that the reality may be different.

Buyer power

UnumProvident has also contended that the presence of strong buyers is likely to act as a significant constraint on its future competitive behaviour. This strength is said to arise from (1) buyers' ability to provide an equivalent to Group Risk cover in-house, and (2) buyers' reliance on intermediaries to negotiate cover.

Self-insurance

The parties submitted that provision of GIP in-house was a reasonable alternative for larger customers. Recent examples of companies cancelling their GIP schemes were provided, but it was unclear why these policies had actually been cancelled. While cancellation of a policy may have been as a result of switching to self insurance, it is also possible that the customer decided to cease GIP provision or simply switched to another provider without the parties' knowledge. The parties also submitted information on 1 GL and 3 GIP clients that had either switched to self insurance or were looking to do so in the near future. The contracts identified by the parties represented significant premium income (between £0.8 and £2 million). Despite this evidence, our investigation has raised questions over the ability or willingness of customers to provide cover in-house. Few of the customers we spoke to said they would consider self-insurance in the face of a 5-10 per cent increase in premiums.

Role of intermediaries

The parties argued that intermediaries played an important role in the bidding process and any increase in price or reduction in service would result in intermediaries recommending alternative providers. It is estimated that over 90 per cent of sales in the Group Risk sector are through intermediaries, with third parties stating that around 20 intermediaries dealt with the majority of Group Risk contracts in the sector.

Intermediaries are expert in negotiating insurance contracts and might be expected to be able to address some of customers' concerns. The presence of intermediaries results in suppliers often facing well informed and sophisticated buyers. However, all of the intermediaries we contacted had concerns about the merger, citing loss of choice, particularly for larger contracts, as a significant concern. Of course, buyer power depends on choice.

Switching

The parties submitted evidence of contracts recently lost to other providers to demonstrate that customers can choose from a large number of alternative providers and switching regularly occurs. The information provided only represents a small sample of the number of contracts that come up for re-bid each year. The parties argued that the low churn (see note 4) rates ([ ]-[ ] (see note 5)) observed in the sector were due to quoted prices being very similar, and therefore the customer had no real incentive to switch unless a better offer was made. It is true that low churn rates (see note 4) need not be indicative of a low level of competitiveness. However, historical data for the Group Risk sector shows that shares have generally remained rather static over the last ten years. Increases in share have primarily resulted from acquisition and, in previous cases, it appears that the merged entities have been able to retain nearly all of their combined share post acquisition.

Because each policy comes up for renewal on one- or two-year cycle buyers have a regular opportunity to switch providers, although the regularity of renewals might not ensure competition if the cost of switching insurer is significant or there is limited choice of provider. Concerns regarding the availability of choice were particularly significant with respect to larger contracts, where the number of alternative bidders will effectively be reduced from three to two. The conflicting evidence of the merging parties and third parties

regarding the ease of switching, coupled with our own observations, leads us to conclude that post-merger constraints from buyer power on the merged entity cannot be relied upon to prevent a substantial lessening of competition.

Third party comments

Of the third parties we contacted, the majority were concerned about the proposed transaction. All of the intermediaries and competitors had concerns about the merger, while customers were more mixed in their views. Intermediaries cited loss of choice, recent levels of consolidation in the industry, high market shares and loss of Swiss Life as a competitive force as their major concerns. Competitors were also concerned with the merged entity's ability to "cherry pick" contracts leaving competitors to insure the poorer risks, and the creation of dominant player with the possibility to engage in predatory pricing.

Counterfactual

Whether or not a substantial lessening of competition may be expected to result from a merger depends in part upon what would happen in the absence of the merger – that is, the counter-factual. Generally, three possible counterfactuals to the proposed acquisition have been advanced: (1) Swiss Life continues to operate and bid for Group Risk contracts in the UK; (2) an alternative purchaser acquires the Swiss Life Employee Benefits business; or (3) the Swiss Life book is run off.

In September 2002 the Swiss Life Group announced its intention sell Swiss Life (UK) plc as part of a new strategy focusing on European country markets where it has a strong position in the overall life business. Following this, in July 2003 it announced its intention to close its UK Employee Benefits business and exit the UK if a suitable solution could not be found by mid-August. Swiss Life has already closed to new business in the UK, although they continue to quote for renewals as part of their deal with UnumProvident[3]. UnumProvident stated that if the proposed transaction does not go ahead, Swiss Life will not seek to find an alternative buyer and will simply put the business into run off.

The participation of Swiss Life in this sector going forward is therefore unlikely. Swiss Life has publicly made it clear that it intends to exit from the UK Group Risk sector. While it is continuing to re-bid for renewals, this is a result of an agreement with UnumProvident to maintain the value of the business as an ongoing prospect. Nevertheless, it difficult completely to rule out the possibility, however unlikely, that Swiss Life may change its strategy and continue operating in the UK Group Risk sector (see note 8).

The prospect of an alternative purchaser acquiring the employee benefits business of Swiss Life also appears to be uncertain. One third party we spoke to noted that the Group Risk business had not been offered for sale as a separate entity[4] and that it could potentially be interested in such a purchase. The majority of third parties considered that the most likely outcome would be that the Swiss Life book was run off.

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[3] Until the end of 2003.

[4] Swiss Life (UK) plc which comprises both individual and group policies was offered for sale as a package. The Employee Benefits part of Swiss Life was never publicly offered as a separate business for sale.

Based on the evidence, the run off of Swiss Life's book appears the most likely of the three alternatives considered. This is a view generally supported by both the parties and the third parties which were contacted. Regardless of the view taken as to the appropriate counterfactual, the proposed transaction appears to give rise to the prospect of a significant lessening of competition in the GIP, GCI and GL segments.

In the event that Swiss Life was to continue as a competitor, even in a diminished form, it would still provide an additional competitive constraint that would otherwise be absent following the merger. On the second alternative, purchase of the Swiss Life business by either a new entrant or an existing competitor would result in the creation of another medium to large player capable of competing effectively with UnumProvident. In both these situations, the number of large providers would remain at three, as opposed to the proposed transaction where there is a reduction from three to two. Finally, the run off of the Swiss Life book would provide an opportunity for all players in the Group Risk sector to compete for Swiss Life's business, which in this instance, is likely to promote competition to a greater extent than the proposed transaction, where UnumProvident will retain the vast majority of the Swiss Life book. Indeed, competition can be intense at the point where a competitor is exiting the market, creating an open opportunity for the remaining suppliers to vie for its customers.

CONCLUSION

The merger would reduce the number of major suppliers of GL, GIP and GCI from three to two, with the merged entity holding a [30-40 per cent] (see note 3) share of supply (before estimated policy lapses) in the GL insurance segment and more than half the GCI and GIP business in the UK.

High potential shares of supply do not necessarily indicate prospective market power. First, the products in question might face competitive constraints from alternative choices open to customers – for example switching to an alternative provider, choosing to end Group Risk provision or opting to self-insure. However, evidence from third parties indicates that switching may be limited following the merger, particularly for large contracts, and self-insurance is not considered a viable alternative for the majority of customers.

Second, other major insurers might bring about potential competition via entry and expansion in the supply of group risk products. Although other insurers appear to have relevant resources and capabilities to enter and expand in the Group Risk sector, none appears to have been particularly successful in winning business from larger providers. Shares of supply have been relatively stable over time, perhaps reflecting switching costs and informational advantages of incumbency.

At the OFT stage of investigation, therefore, it cannot be assumed that competitive pressures are significantly strong to remove the prospect that the merger might substantially lessen competition. Moreover, the widespread competition concerns of third parties – especially intermediaries – are notable. The OFT therefore believes that it is or may be the case that the merger may be expected to result in a substantial lessening of competition in the supply of Group Risk products in the United Kingdom.

DECISION

This merger will therefore **be referred** to the Competition Commission under section 33(1) of the Act.

NOTES

1 Source: GE Frankona Group Risk Survey 2003.

2 Actual figures replaced by a range, or deleted for reasons of copyright or commercial confidentiality.

3 Actual figures replaced by a range at the request of the parties for reasons of commercial confidentiality.

4 UnumProvident requested that the word 'switching' be used rather than churn, as churn means non-customer driven switching of suppliers by intermediaries.

5 Text or figure(s) deleted at the request of the parties for reasons of confidentiality.

6 Based on third party estimates which were incorrectly quoted as an annual figure. UnumProvident considers the number of contracts it re-bids for each month to be higher (approximately 1300-1400 per month).

7 This should read Individual IP, Individual CI and Individual Life.

8 The parties have requested that it be made clear that this statement reflects the opinion of the OFT.

9 Actual figure replaced by a range at the request of BUPA for reasons of commercial confidentiality.