

## Potential for entry and expansion

### Introduction

1. This appendix sets out the potential for entry and expansion<sup>1</sup> in the supply of members' agency services and assesses the extent to which the potential for entry and expansion may constrain members' agents' behaviour with respect to fees (including profit commission) and service quality.
2. The analysis is based on information provided by the main parties and various third parties, including several Lloyd's market participants, potential entrants and the FSA. Also included, where relevant, are the results of the customer survey carried out on our behalf by Harris Interactive.
3. According to the CC's *Merger Guidelines*, in order to evaluate the potential for entry and expansion, we need to look at (a) the risk firms face, (b) barriers to entry or expansion and (c) the effects the merger itself has on entry or expansion. We shall also take into account (d) the history of entry or expansion and evidence of planned entry or expansion. This appendix considers each of these factors (a) to (d) in turn.

### (a) The risks firms face

4. In general, the greater the unrecoverable cost of unsuccessful entry and expansion in a certain market, the more risky it is to enter or expand in that market and the less likely such action is. A declining market generally implies a higher risk for potential entrants than would a constant or growing market, as the necessary investments to enter the market may not be recouped in the form of future profits. Similarly, expansion would generally be difficult to achieve in a declining market.
5. With respect to the supply of members' agency services, all respondents (including the main parties) have indicated that this market has been declining for almost two decades and that it is therefore unattractive for potential entrants. Evidence of this decline includes the following:
  - (a) The number of individual members with unlimited liability has fallen from 32,433 in 1988 (underwriting 100 per cent of Lloyd's capacity of £11 billion) to 1,497 in 2006 (underwriting 9.7 per cent of Lloyd's total capacity of £14.8 billion).<sup>2</sup> When taking into account the NameCos and other limited liability vehicles advised by members' agents, the proportion of Lloyd's capacity provided by members advised by members' agents is 19.4 per cent (in 2006).<sup>3</sup>
  - (b) The number of syndicates has declined from 376 in 1988 to 64 in 2006 (of which 29 currently accept unaligned capital).

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<sup>1</sup>Note that what is meant here is natural expansion (ie by organic growth rather than acquisition).

<sup>2</sup>Source: Standard & Poor's, *Standard & Poor's Rating of the Lloyd's Market*, February 2006.

<sup>3</sup>Source: Lloyd's.

(c) There has also been a sharp decline in the number of members' agents (from over 200 in 1988 to two in 2006).<sup>4</sup>

6. As Lloyd's ceased admitting new unlimited liability members from 6 March 2003, the number of individual members with unlimited liability will inevitably decrease further over the next decade, given that their average age was 64 in 2005. Individuals who wish to continue to underwrite at Lloyd's may do so through limited liability vehicles such as NameCos, SLPs, and (from 2007) LLPs. As these vehicles are, like individual members, required by Lloyd's to appoint and retain a members' agent under paragraph 24 of the Membership Byelaw, demand for members' agency services may continue to exist.
7. A few parties have indicated that demand for members' agency services, after a period of decline, has now stabilized. Some even suggested that demand for members' agency services may pick up if underwriting at Lloyd's becomes more attractive (ie more individuals may become interested in underwriting at Lloyd's through a limited liability vehicle).<sup>5</sup> In contrast, others believe that there is no long-term future for unaligned capital on Lloyd's syndicates, and therefore that the members' agents will not have a long-term role in advising the providers of unaligned capital.
8. Different views have been expressed as to whether demand for members' agency services will decline further or whether it will remain constant or even pick up in the near future. Uncertainty about demand increases the risks both for potential entrants and for members' agents seeking to expand their business, and as a result makes entry or expansion in the near future less likely.

## **(b) Barriers to entry or expansion**

9. There are different types of barriers to entry. The CC's *Merger Guidelines* distinguish (i) intrinsic, (ii) regulatory, and (iii) strategic barriers to entry. We discuss each of these in turn in the following paragraphs, with respect to the supply of members' agency services to active individual members of Lloyd's.

### **(i) Intrinsic barriers to entry or expansion**

10. Natural or intrinsic barriers to entry or expansion are the unavoidable costs necessarily incurred when setting up or expanding a commercial operation, in this case a members' agency. Possible intrinsic barriers to entry or expansion in the members' agency business include sunk investments, customer loyalty, capital requirements and the limited availability of experienced names executives. We discuss each of these in turn below.

#### *Sunk investments and economies of scale*

11. According to a broad estimate provided by CBS, setting up a members' agency from scratch requires investment of £1.5 million to £2 million (working capital related to acquiring about ten names executives,<sup>6</sup> supporting staff, equipment, regulatory costs and solvency capital). As the largest part of these costs are costs of human capital,

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<sup>4</sup>Source: Lloyd's.

<sup>5</sup>However, HAL notes that over the course of the last three years, the number of Lloyd's members has fallen by over 20 per cent and despite the introduction of LLPs, HAL's figures indicate that there will be a continuing decline in the number of its clients underwriting for 2008.

<sup>6</sup>Individual members are also referred to as 'names'.

they are largely sunk (ie not recoverable upon exit from the market). To cover these setup costs and ongoing costs of staff etc, a new entrant would need to attract approximately 150 to 200 members, assuming average fees of £10,000 per member. Hampden considers the minimum efficient scale lies closer to an annual turnover of £5 million or 500 to 750 members. Argenta has argued that size is important to offset increased regulatory costs.<sup>7</sup>

12. Evidence on economies of scale in the members' agency business is mixed. Some respondents have argued there are limited economies of scale, given the personal character of the services provided. However, others have argued that the largest part of costs is fixed (so that average cost per member decreases as the number of members increases) and that there are economies of scale to be obtained from sharing research and other back office activities. HAL has submitted to the OFT that one of its principal reasons for the acquisition of CBSPC was to benefit from economies of scale.
13. The costs of exiting the supply of members' agency services are modest. The main cost component is the administering of members in run-off, which, depending on the time they have already been in run-off, costs approximately £200,000 to £300,000 according to HAL. It is unlikely that exit costs act as a significant barrier to entry in the members' agency business.

### *Customer loyalty*

14. HAL, CBSPC and Argenta considered that most members were loyal to their members' agents, more specifically to their names' executives. The customer survey carried out by Harris Interactive shows that 28 per cent of active individual members that currently have a primary personal contact, or names' executive, with their members' agent would switch to another members' agent if their names' executive took up employment with that members' agent. Switching between members' agents for reasons other than acquisition has generally been low in recent years.<sup>8</sup>
15. Customer loyalty and low switching rates imply that customers may not be willing readily to switch to a new entrant or to another members' agent in the case of entry or expansion. Entry or expansion would require investment in acquiring or strengthening reputation that could not be recouped upon exit (ie sunk costs) and which therefore may constitute a barrier to entry or expansion.

### *Availability of capital*

16. It is possible that potential new entrants may find it difficult to gain sufficient capital to fulfil the FSA's and Lloyd's requirements (see paragraphs 20 and 23) and to obtain the minimum efficient scale. Capital providers may not be willing (or only against a significant risk premium) to provide capital to firms that wish to enter a declining market, which may raise barriers to entry. However, there are no particular indications that this would be the case for potential entrants in the supply of members' agency services.

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<sup>7</sup>Argenta considered that regulatory costs had risen sharply since members' agents had been authorized by the FSA under the FSMA 2000.

<sup>8</sup>According to Lloyd's, between 2005 and 2006, six members switched (from CBS to HAL). Between 2004 and 2005, 70 members switched between members' agents in addition to the switching that occurred following the Argenta-Anton merger. Between 2003 and 2004, 17 members switched between members' agents.

### *Availability of qualified staff*

17. Various parties, including Hampden, consider that there is only a small pool of people who have sufficient specialized knowledge of Lloyd's, and that staff do not frequently move between different members' agents (and would not be expected to move readily to new entrants). It is possible that any staff-related barriers may be lower in the case of expansion by an existing members' agent, as compared with a new entrant to the market. Similarly, managing agents may find that their presence and contacts in the market may enable them to overcome any staff-related barriers to diversifying into the provision of members' agency services.
18. The OFT stated in its decision that it did not receive any evidence to suggest that there were significant barriers to expansion. However, it did not believe that Argenta's potential expansion would offset the concerns that HAL may be able to charge fees higher than it would otherwise have been able to and/or to reduce the quality of service that it otherwise would have provided absent the merger.<sup>9</sup>

### ***(ii) Regulatory barriers to entry or expansion***

19. There are two potential regulatory barriers to entry to the members' agency business: to become a members' agent, one needs (a) FSA authorization and (b) Lloyd's approval. Existing members' agents seeking to expand their business do not need further FSA authorization or Lloyd's approval, but are subject to ongoing monitoring.

### *FSA authorization*

20. In addition to the general authorization to carry out regulated business, a new entrant would require a specific permission related to the regulated activities in question (ie supplying members' agency services). Those firms that already have general authorization and a specific permission for other trade areas need to apply for a variation of the terms of their permission to include the supply of members' agency services. Once firms have obtained FSA authorization to act as a members' agent, they are subject to ongoing monitoring by the FSA.
21. FSA authorization is conditional upon the new entrant meeting threshold conditions, including being sufficiently resourced in terms of staff and capital. According to the FSA, the capital requirements for members' agents are fairly basic and capital is usually not a major issue in the authorization process of members' agents. In addition, the FSA needs to be satisfied the new entrant has sufficient knowledge about the Lloyd's market and is able to provide good quality members' agency services. The FSA is, among other things, concerned with the fair treatment of customers and needs to be satisfied that a new entrant will have due regard to their interests.
22. The FSA authorization process has standard fees and does not require the applicant to have legal representation. The complexity and duration of the authorization process depends on the complexity of the proposed business model. The authorization process can take up to six months, but in practice it is often shorter. Whether the FSA is already familiar with the firm requesting authorization can have a

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<sup>9</sup>Hampden notes that since the announcement of regulatory investigation into the merger, Argenta has concentrated on advertising its services to members represented by HAL/CBPC. According to Hampden, Argenta's efforts to recruit such members have proved more successful following the merger than in previous years—approximately six (former CBSPC) members have transferred to Argenta this year.

significant impact on the duration of the authorization process. No firm has sought authorization as a members' agent in the past five years (see paragraph 33).

### *Lloyd's approval*

23. In accordance with Lloyd's Underwriting Byelaw, an applicant seeking Lloyd's approval to act as a members' agent must demonstrate that it is a suitable company to be permitted to act in that capacity. In accordance with Lloyd's Underwriting Requirements, made under the Underwriting Byelaw, in deciding whether an applicant is suitable to act as an underwriting agent, Lloyd's has regard to various criteria concerning capital resources, reputation, quality and adequacy of human resources. Lloyd's requirements generally track the FSA's, and Lloyd's approval process would generally take eight weeks from the date of receiving a complete application.
24. It appears that there is limited scope for innovation—to attract customers—by new entrants or expanding incumbents, given the detailed prescription of the services that are to be provided by a members' agent as set out in the Lloyd's members' agency agreement.<sup>10</sup> However, it is open to members' agents to apply under the Agency Agreements Byelaw to vary the terms of the standard form members' agency agreement (for example, to seek to add to or vary the services to be provided). Lloyd's has not received any such applications.

### *Regulatory barriers to entry*

25. Both the FSA and Lloyd's consider that their requirements do not constitute a significant regulatory barrier to entry. There have been no applications from prospective new members' agents in recent years, and hence no evidence of how the process works in practice. The need for staff with a high degree of knowledge of the specialized Lloyd's market may potentially act as a barrier, especially for new entrants. Lloyd's has suggested to us that outsourcing arrangements (or other methods of teaming up with companies already in the market) may help to overcome this possible barrier.

### ***(iii) Strategic barriers to entry or expansion***

26. Barriers to entry or expansion may be raised by strategic behaviour of the incumbent members' agents. Even when deterring entry is not the main purpose of an incumbent's behaviour, investing in reputation, for example, may increase the necessary (sunk) investments for entering the market. Similarly, members' agents providing discounts to certain members may increase switching costs for those members, making it more difficult for new entrants or existing competitors to attract customers.
27. The information provided to us shows no indications of explicit strategic entry-detering behaviour by the incumbent members' agents, although it could be argued that the declining market and lack of entry attempts (see paragraph 33) have rendered such behaviour unnecessary.
28. However, it should be noted that there are examples of members' agents poaching names' executives from other members' agents, possibly preventing them from expanding their business. One potential entrant has indicated that it suspects that, if threatened (by expanding competitors or potential new entrants approaching their

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<sup>10</sup>See the Lloyd's members' agent's agreement, clause 4.

names' executives), the existing members' agents would give their names' executives certain incentives to stay with them. Hampden has submitted that members' agents will use their best endeavours to retain the services of key staff.<sup>11</sup>

### **(c) Effects of the merger on entry or expansion**

29. It is possible that the merger itself may have the adverse effects of eliminating an important potential source of expansion, although the information provided to us indicates that CBSPC was not planning (or able) to expand its members' agency business in the near future.
30. The merger may also have made it more difficult for potential entrants by eliminating one route of entry, ie acquisition of CBSPC.<sup>12</sup> In addition, the merger may have increased the minimum efficient scale necessary to operate and successfully compete in the members' agency business.
31. Finally, in theory, it is also possible that changes in the market caused by the merger would make members more alert and aware of their choice of members' agent, possibly stimulating switching behaviour and thereby providing incentives for new entry or expansion. However, various respondents have pointed at the high degree of customer loyalty and low switching rates in the market (see also paragraphs 14 and 15). This is illustrated by the fact that nearly all former CBSPC members have followed CBSPC names' executives to HAL following the merger.

### **(d) Past entry and discussion of the position of other companies**

32. We have analysed the history of entry in the market, and have also considered the relative positions of other companies, including:
  - (a) LMAS;
  - (b) Newton Follis;
  - (c) Patrick Moore;
  - (d) other financial advisers;
  - (e) managing agents; and
  - (f) Argenta.

We first discuss the history of entry, before considering each of these companies in turn below.

#### ***Past entry***

33. On the basis of information provided by Lloyd's, there appears to have been no successful entry in the supply of members' agents' services in the past 20 years. The FSA has confirmed that no entity has applied for authorization to become a members' agent during the past five years.

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<sup>11</sup>HAL notes that this is in common with any other commercial organization.

<sup>12</sup>Note that if a non-members' agent (ie potential entrant) were to acquire CBSPC, it would still need to seek (to expand its) FSA authorization and Lloyd's approval to register as a members' agent with Lloyd's.

34. As stated in paragraph 5, there has been a sharp decline in the number of members' agents in the last two decades due to consolidation or exit in reaction to declining demand. According to Hampden, no companies that have exited the market have expressed an appetite to return to the members' agency business.

### ***Assessment of other companies***

35. We have examined a number of companies who are closely related to the members' agency business: LMAS, Newton Follis, and Patrick Moore.<sup>13</sup> Whilst a number of parties suggested to us that these companies could potentially enter the members' agency market, all three have stated that they were not interested in doing so.
- (a) Lloyd's has indicated that it does not consider it appropriate for LMAS to offer research and syndicate advice, as this would conflict with Lloyd's wider role and responsibilities in supervising the market.
  - (b) Newton Follis has told us that it has no intention of establishing a members' agency because of the declining number of members and the nature of the Agency Agreement.
  - (c) Patrick Moore has told us that he has no intention of entering the supply of members' agency services because he is not prepared to risk the capital in doing this.
36. We also considered other financial advisers, including Artannes Capital Limited and financial analysts such as Moody's, AM Best, Standard & Poor's, and Fitch.<sup>13</sup> There are no indications that any of these companies is interested in entering the members' agency business.

### ***Managing agents***

37. We examined the position of managing agents, with particular regard to the question of whether such companies would be more able and willing to set up a members' agency business and enter the market. In the past, several managing agents also operated a members' agency. Being already active in the Lloyd's market, managing agents may find it easier than others to fulfil the FSA's and Lloyd's requirements regarding the knowledge and skills of staff.
38. However, the Lloyd's Underwriting Byelaw, which was made by the Council on 4 June 2003, states that the Franchise Board<sup>14</sup> shall not grant permission for an underwriting agent to act both as a managing agent and as a members' agent.<sup>15</sup> Lloyd's noted that this should be seen in the context of one underwriting agent performing both roles (because of conflicts of interest). However, a group which includes a managing agency business could establish a separate company which could apply for authorization as a members' agent. There are currently no indications that existing managing agents aspire to enter or re-enter the members' agency business. None of the managing agents that have submitted information to the OFT or to us expects there will be any sizeable entry in the next three years.

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<sup>13</sup>For a description of the business of these companies, see Appendix E: Market definition.

<sup>14</sup>The Franchise Board is part of the management of the Lloyd's market. The Franchise Board sets the franchise strategy, and is responsible for risk management and profitability targets across the market.

<sup>15</sup>See paragraph 8(e) of the Lloyd's Underwriting Byelaw.

### ***Potential expansion: Argenta***

39. Argenta has indicated that it could 'readily expand its business to take on any new business won from HAL or new businesses'. However, it considered that current clients (members) did not tend to switch without their client director (names' executive). As discussed in paragraphs 14 and 15, customer loyalty may act as a barrier to expansion.

### **Conclusion**

40. Based on the above analysis of (a) the risk firms face, (b) barriers to entry or expansion, (c) the effect of the merger on entry or expansion and (d) the history of entry or expansion and evidence of planned entry or expansion, it seems unlikely that there is significant potential for entry or expansion to offset any potential adverse effects in the supply of members' agency services resulting from the merger.