COMPETITION TRIBUNAL OF SOUTH AFRICA

Case No: 57/LM/Aug09

In the matter between:

Santam Limited Acquiring Firm

and

Emerald Insurance Company Limited; and

Emerald Risk Transfer (Pty) Ltd Target Firms

Panel : N Manoim (Presiding Member)
A Ndoni (Tribunal Member)
A Wessels (Tribunal Member)

Heard on : 28 October 2009

Order issued on : 30 October 2009

Reasons issued on : 27 January 2010

Reasons for Decision

APPROVAL

[1] On 30 October 2009, the Competition Tribunal ("Tribunal") approved the acquisition by Santam Limited of Emerald Insurance Company Limited and Emerald Risk Transfer (Pty) Ltd. The reasons for approval follow.

THE PARTIES

[2] The primary acquiring firm is Santam Limited ("Santam"). Sanlam Limited ("Sanlam") controls Santam. Sanlam is controlled by a number of shareholders.

[3] Two target firms are relevant to the proposed deal, namely (i) Emerald Insurance Company Limited ("Emerald") and (ii) Emerald Risk Transfer (Pty) Ltd ("ERT"), trading as Emerald Underwriting Managers ("EUM"). Emerald is a wholly owned subsidiary of Super Group Limited ("Super Group"). Super Group

is a public company with no single shareholder holding sufficient shares to control it. The premerger shareholders of ERT are Super Group (38%), Gary Steven Corke (27.75%), Dave Manuel (27.75%) and the Senior Management Trust (6.5%).

THE TRANSACTION

[4] Santam proposes to acquire 100% of the issued share capital in Emerald from Super Group, as well as 100% of the issued share capital of ERT, 38% from Super Group and 62% collectively from management, i.e. Gary Steven Corke, Dave Manuel and the Senior Management Trust. Once Emerald has been acquired the Emerald short term insurance licence will be run-off and its insurance book transferred to Santam, i.e. a portfolio transfer will occur into the Santam licence. Furthermore, an internal restructuring will be effected in terms of which all the Santam short term corporate insurance underwriters will be transferred to Emerald, which will continue as a wholly owned underwriting manager of a Santam investment company, Swanvest 120 (Pty) Ltd. This specialist corporate underwriter will operate as "Emerald underwritten by Santam".

BACKGROUND TO THE HEARING

Summary of views

Competition Commission

[5] The Competition Commission ("Commission") recommended to the Tribunal that the proposed transaction be approved, primarily on the following grounds: (i) the likely failure of Emerald and the resultant effect thereof on the market (see paragraphs 50 and 51 as well as 56 to 65 below); and (ii) the retention through the proposed deal of a significant portion of the underwriting capacity in the South African short term corporate insurance sector as well as the innovative underwriting method/strategy of Emerald/EUM, which would benefit consumers (i.e. corporate clients). However, the Commission also concluded that the proposed deal would result in the removal of a maverick Emerald/EUM as an effective competitor in the said sector. The Commission identified no competition

concerns regarding coordinated conduct in any relevant market as a result of this proposed transaction.

Third parties

[6] Certain third parties, i.e. competitors, brokers and their clients, expressed concerns regarding the effects of the proposed transaction on market capacity and competition between progressively fewer significant players in the short term corporate insurance sector. The issues raised include concerns that the proposed deal would (i) reduce capacity in the short term corporate insurance sector because reinsurers would not extend reinsurance to a total equal to the sum of the separate entities' reinsurance; (ii) limit capacity/appetite for certain business, for example retail; and (iii) remove from the market a cooperative (flexible) and innovative competitor who is solution driven and willing to take on larger risk exposure.

[7] On the other hand, other third parties foresaw no competition concerns resulting from the proposed deal or were of the opinion that the merger was pro-competitive given *inter alia* that (i) it would move Emerald to a more sustainable business model with greater emphasis on risk management; (ii) a union with Santam would give Emerald access to sufficient solvency capital to write more risk; and (iii) it would provide greater financial security for corporate clients given the Super Group difficulties and the impact of this on Emerald.

[8] The Tribunal invited the brokering firms Marsh and Glenrand M-I-B, as well as Shoprite Checkers, to partake in the hearing of this matter; they however declined this invitation.

Witnesses

[9] The Commission did not call any witnesses to testify at the hearing. At the request of the Tribunal, the following representatives of the merging parties gave evidence at the hearing:

- Mr. Gary Steven Corke ("Corke"), the managing director of Emerald and CEO of ERT; and
- Mr. Quinton Matthew ("Matthew"), Santam's head of specialist business.

RATIONALE FOR THE TRANSACTION

[10] As rationale for the proposed deal, Super Group submits that it is refinancing its business and selling its non-core assets and Santam submits that it will allow it to acquire Emerald's insurance book and ERT's skilled underwriters. Santam further submits that this is aimed at improving its short term corporate insurance business by adopting a new business/underwriting approach which incorporates the best of the ERT and Santam's core skills and philosophies.

[11] A review of Santam's strategic documentation and the testimony of Matthew make it quite clear that Santam wishes to revitalise its approach to short term corporate insurance by adopting the "innovative" underwriting manager models and (reinsurance) strategies of Emerald. Matthew gave a rather grim account of Santam's short term corporate insurance results over the past three years and also confirmed an underwriting loss in the current year to date. He testified that Santam needs to "*change the business model in terms of the flexibility, the solution orientation, the way that we [Santam] conduct our business, the use of our insurance markets* ..."; that "... *going forward we [Santam] marry the philosophy of Santam with the entrepreneurship of Emerald to our future business";* that "*the structure of the Emerald basis of working under EUM as an underwriting manager is one that we [Santam] are looking to continue into the future*"; and that "*we [Santam] ... look to sustain the model and the business as EUM have at present*".

[12] All of this signifies a substantial post merger preservation of the current Emerald/EUM approach to short term corporate insurance and thus alleviates the concerns raised by certain third parties that the more innovative and entrepreneurial approach of Emerald/EUM would necessarily be lost post merger (see paragraph 6 above).

THE RELEVANT MARKET(S)

Overlapping activities

[13] Santam is a diversified general short term insurance provider with product offerings and services in the corporate, commercial and personal business segments, providing a range of insurance products to individuals, small businesses and corporate clients. Emerald's focus conversely is much narrower: its product offerings and services relate to short term corporate insurance, primarily the corporate property and engineering spheres, and as such is classified as a so-called "monoline" insurer.

[14] ERT (t/a EUM) is an underwriting management company that fulfils *inter alia* the function of internal infrastructure of insurance underwriting, claims handling and accounting in terms of regulatory requirements. It has two main business streams: (i) an underwriting manager business (providing underwriting management services to Emerald and its cell captives exclusively); and (ii) the underwriting of risk for its own account in cell captives. Regarding these underwriting management services, EUM and Santam's in-house corporate underwriting managers premerger exclusively provide underwriting services to the Emerald and Santam groups respectively. Post merger, the new underwriting unit will only provide services to Santam.

[15] Therefore, the overlap between the activities of the merging parties is in respect of short term corporate insurance.

Background to short term corporate insurance

Sector regulation

[16] Short term insurers are regulated in South Africa by the Financial Services Board ("FSB") under the Short-Term Insurance Act, 1998 (Act No. 53 of 1998) (the "STIA"). In terms of the STIA, a short term insurer is *inter alia* required to be registered locally with the FSB, and to maintain its business in a financially sound condition (through having assets, providing for liabilities and in the manner it conducts its business). More specifically, a short term insurer must maintain a minimum solvency level of 15%, i.e. its net assets as a percentage of its net premium written in the preceding 12 month period must be at least 15% at all times (also see paragraph 58 below).

Corporate insurance structures

[17] Given the magnitude of corporate risks, no individual insurer wishes to be over-exposed to the risks of any one client or any one sector. Individual insurers may also not have sufficient capacity (themselves or because of treaty restrictions, see paragraph 20 below) to insure a client fully. For this reason, insurers in practice share risks on the asset and other insurance programmes of larger corporate clients. This spreading of risk is also a consideration for the insured who may wish to spread its risk amongst a number of insurers. As a result, short term corporate insurance is structured in a number of ways, the most relevant of which are (i) coinsurance contracts, which are the most prominent structure in practice; and (ii) layered programmes.[1]

(i) **Coinsurance contracts**

In these contracts each insurer takes a specified percentage of the risk of loss on a specific insurance programme so that the overall risk is spread amongst several insurers. In practice this results in so-called "lead" and "follow" positions taken by the individual insurers:

(a) Lead insurer positions

Typically the lead insurer would take the largest portion of the risk, perform the risk assessment, set the premium rates, negotiate the terms of the contract, handle any loss negotiations and decide on any settlement in the event of loss occurring. This lead insurer would typically earn a 2.5% coinsurance fee for performing these tasks (also see paragraph 92 below).

(b) Follow insurer positions

Follow insurers would take up the remainder of the risk not taken by the lead insurer. These follow insurers generally take smaller percentages of the risk and follow the premium rates and terms negotiated by the lead and

[1] Other structures include separate contracts. However, this will not be discussed since it does not appear to be common, given that it is undesirable, costly and cumbersome from a client perspective to deal separately with each insurer.

also accept the settlements negotiated by the lead insurer (also see paragraphs 91 and 92 below).

(ii) Layered programmes

Layered programmes are similar in their intent to coinsurance contracts. In this case the asset protection or other programme would be layered into primary and secondary risk layers with insurers taking a percentage of the risk in each layer. The primary layers would be those that would take the initial losses on the happening of any risk event with the secondary layers taking losses above the thresholds set for the layer.

Reinsurance as secondary market

[18] Given the relative risk magnitude and local market capacity, most South African insurers of corporate clients will utilise a reinsurer to reduce their own risk. An insurer's underwriting capacity is largely driven by the reinsurance capacity granted to it by reinsurers. Consequently, a large portion of the cost of corporate insurance in the primary markets can be attributed to the cost and terms of reinsurance in the secondary market.

[19] Most of the larger reinsurers, whether registered in South Africa or not, are global/international reinsurers. The Commission's market enquiry confirmed that the cost of reinsurance is driven primarily by international factors that often are entirely unrelated to local claims and/or conditions. Reinsurance pricing is mostly affected by (natural) disasters and other major events, for example hurricane damage in America; floods in Europe; and mining disasters in South America. The 11 September terrorist attacks in America for example had a significant effect on the availability and price of reinsurance. Matthew indicated during his testimony that rates and premiums increased by as much as 50% to 70% as a result of withdrawn capacity following this event.

[20] South African insurers of corporate clients use reinsurance extensively and this reinsurance is of two basic types (of which a combination is mostly utilised) viz:

(i) Facultative reinsurance

This is reinsurance acquired for a specific risk. The reinsurer assesses a particular risk and quotes a price for reinsuring that specific risk, for example a hotel in the centre of Johannesburg, an aircraft hanger at an airport or a specific manufacturing plant.

(ii) Treaty reinsurance

This reinsurance is provided in terms of a reinsurance treaty under which the reinsurer obliges itself to reinsure any risks written by the primary insurer up to certain limits and under certain conditions. Given the greater scope of treaty reinsurance and the fact that the reinsurer does not assess the risk itself, the reinsurer will generally want to be satisfied of the skills of the corporate underwriters and the underwriting philosophies of the insurers to whom they grant treaties. This factor reinforces the need to have skilled underwriters with a satisfactory industry track record (also see entry barriers discussed in paragraph 41 below). Furthermore, for the same reasons, treaties will often impose restrictions and conditions on the risks for which reinsurance will be provided, for example (i) treaties often restrict the geographical area within which an insurer may underwrite risks (for example South African insurers may be restricted to underwriting South African and perhaps sub-Saharan African risks); and (ii) certain higher risk industries may be excluded from the treaty or may have to be specifically referred to the reinsurer and accepted before cover is extended.

[21] In the context of the instant transaction, given the issue of an alleged failing firm (see paragraphs 56 to 65 below), the implications of the use of so-called FSB “non-approved” foreign reinsurers are particularly relevant. FSB “approved” reinsurers *inter alia* have an office and a bank account in South Africa. It is noted that the use of foreign reinsurers not registered in South Africa although permissible, places a strain on the FSB required solvency/capital adequacy of insurers. Local insurers have to keep reserves for liability, but the said foreign reinsurance is not taken into account as part of the capital of the insurer in the way approved reinsurance would be. Consequently, an insurer would need to

have the requisite capital to cover this liability, even though this liability has been passed to the reinsurer (also see paragraphs 60 and 61 below).

Pricing and current market conditions

[22] Insurers contacted during the Commission's market investigation emphasized the cyclical nature of pricing in the short term corporate insurance sector, with hard phases (i.e. higher premiums and less consumer bargaining power) and soft phases (i.e. lower premiums and more customer bargaining power). Given the current credit crunch and significant losses suffered in 2007/2008 (fires), the market is generally seen as being a hard one or moving into a hard market cycle. Matthew confirmed the latter general view during his testimony, but pointed out that the cycle can vary according to market segment, for example mining or retail.

Relevant product market(s)

Short term corporate insurance

[23] Short term corporate insurance involves insurance for large South African and multinational firms on broker negotiated terms customised for the client and its specific and complex risks. Despite varying internal definitions[2] of corporate insurance, competitors and customers (including brokers) interviewed by the Commission agree that short term corporate insurance is a distinct market from the other two main short term insurance segments, namely the commercial[3] and personal[4] segments, due to certain core differentiating factors. The Tribunal concurs with the Commission's finding of a separate relevant market for short term corporate insurance, which is distinct from the secondary market for reinsurance, based *inter alia* on the following factors:

(i) Customised contracts

Contracts are unique in the sense that they have and require customized and specialized wording tailored to the particular circumstances and risks of a

[2] Based on, for example, the size of the risk, corporate characteristics, turnovers, premiums, customisation of terms, or various combinations of these factors.
[3] Insurance for small businesses/factories, run by individuals, partnerships, close corporations and small corporates on standard term insurer policies.
[4] Insurance for individuals and their property/risks on standard term insurer policies.

specific corporate client. The wording is not standard insurer policy wording as in the personal and commercial segments, but generated by corporate brokers and negotiated with insurers.

(ii) Scope of risk evaluation

The depth and intensity of the risk assessment and the skills required for this is significantly greater than that required for the commercial and personal segments. Insurers of corporate clients may for example use engineers and technical staff to assess the client's premises for risk.

(iii) Underwriting skills requirement

There is a relative difficulty in rating and assessing the risks of a large corporate, given the size, gravity and complexity of the risks. This is *inter alia* a function of the clients' geographical or international spread (different risk environments), the complex or specialised nature of their operations (for example retail or mining) and the variety of their activities. As such, a short term corporate insurer requires highly skilled corporate underwriters, which is largely acquired through many years of experience rather than through academic qualifications alone. The Commission furthermore found that these skills are in critical short supply in South Africa.

(iv) Risk size and severity

The sheer size and severity of short term corporate risks necessitate:

(a) a sharing of risk amongst insurers through coinsurance contracts and layered programmes (see paragraph 17 above);

(b) favourable balance sheet and solvency requirements of insurers (smaller players may have to rely extensively on reinsurance) (also see paragraphs 18 to 21 above and paragraph 41 below); and

(c) favourable credit ratings, for example 'triple A' ratings of insurers by rating agencies (also see paragraph 41 below).

Distinction between lead and follow short term corporate insurers

[24] The Commission in its recommendation to the Tribunal states that a case might be made for a further delineation of the short term corporate insurance

market into (i) lead and (ii) follow markets, but it does not conclude on this issue. The Commission states that given the lack of fully satisfactory evidence on whether Emerald could be classified as a usual lead market player, it has not pursued this issue.

[25] The Tribunal is of the view that the Commission in the context of this transaction ought to have pursued and concluded on whether or not the lead market is a distinct relevant market for competition purposes (also see paragraphs 91 to 100 below).

[26] Based on the (limited) available information it seems plausible that the lead market could be a separate relevant market for competition purposes. It is clear that the prevalence of coinsurance contacts and layered programmes significantly impact the structure of the market. The available evidence also unambiguously shows that certain players participate primarily in the lead market as opposed to the follow markets, or vice versa. Furthermore, the available information points to significantly larger entry barriers into a potential lead market compared to a follow market; any potential new entry is likely to be limited to follow positions (see paragraph 43 below). However, the typical players in a potential follow market do occasionally take lead positions. From the limited available information it is unfortunately impossible to pinpoint the prevailing circumstances under which the latter could or could not occur (also see paragraphs 91 to 100 below).

[27] Given the fact that it cannot be concluded, based on the limited available information, that the lead and follow markets are not distinct relevant markets, this matter will be assessed on the basis that a distinction may be drawn between the likely impact of the proposed deal on potential lead and follow markets (see paragraphs 88 to 100 below).

Relevant geographic market

[28] From a geographic market definition perspective the Commission, based on its market investigation, makes a distinction between short term corporate

insurance to South African corporate clients (including perhaps Africa operations) and mega-corporates/multinationals. The Commission concludes that the scope of the relevant geographic market for the former group of corporate clients is national, and international in relation to the latter group and possibly in relation to certain very specialized risks areas, for example aviation.

[29] The Commission summarises the factors that are indicative of a national market for short term corporate insurance to South African corporates as follows: (i) legislative barriers[5]; (ii) more competitive premiums locally; (iii) the need for higher premium volumes to interest offshore insurers; (iv) higher deductibles offshore; (v) offshore insurers' preference for participating in secondary risk layers; (vi) higher transactional costs offshore; and (vii) the lack of local/African knowledge and easier settlement of claims locally.

[30] We shall analyse the transaction on the narrowest possible geographic market definition, i.e. at national level.

COMPETITION ANALYSIS

Market participants and shares

[31] Premerger there are nine active participants in the South African short term corporate insurance market, namely ACE, AIG, Allianz, Emerald, Etana, Lion of Africa, Mutual & Federal ("M&F"), Santam and Zurich. ABSA and RMB are either very recent entrants or potential new entrants (see paragraph 43 below).

[32] Since the FSB[6] does not have accurate information on short term corporate insurance as a separate category, the Commission obtained Gross Premium Written[7] (GPW) information for short term corporate insurance from the

[5] South African risks cannot be insured offshore with non-registered insurers, unless it can be shown that (a) local insurers do not have the capacity to take the risk; or (b) better premiums and terms can be obtained offshore.
[6] For the purposes of the legislative scheme of the STIA, insurance has been divided into eight statutory categories viz: (i) accident and health; (ii) engineering; (iii) guarantee; (iv) liability; (v) miscellaneous; (vi) motor; (vii) property; and (viii) transportation. Statistical information is provided to the FSB by insurers in terms of these categories.
[7] GPW is a generally accepted industry benchmark amongst insurers.

individual insurers.[8] (Note that no market share information is available for the lead and follow markets as potential distinct relevant markets.)

Table 1 Market shares for 2008 for a South African market for short term corporate insurance

Market participant	Market share
Santam	[10-20]
Emerald	[10-20]
Combined entity	**[30-40]**
Mutual & Federal (M&F)	[20-30]
AIG	[10-20]
Allianz	[0-10]
Zurich	[0-10]
Lion of Africa	[0-10]
ACE	[0-10]
Etana	[0-10]

Source: Confidential information submitted by each participant, based on GPW.

[33] If market share information is analysed over a three year period (i.e. from 2006 to 2008), Santam's market share decreases very significantly (also see paragraph 11 above), whilst the market shares of specifically Emerald and ACE increase significantly.

[34] Regarding Santam's loss of market share Matthew testified that of some R250 - R300 million worth of Santam lost business, less than R30 - R40 million went to Emerald, and the balance to the other market participants, specifically AIG, ACE and M&F. Matthew attributed this lost business mainly to Santam's stringent risk management requirements (for example insisting on the client installing a sprinkler system and putting fire extinguishers in certain parts of a building), rather than to price or deductibles. According to Matthew, Santam's learning is that clients need to budget for some of these requirements which require longer lead times to implement them. To address this issue going forward, Santam may take smaller shares in riskier industries and/or structure a reinsurance program around it, according to Matthew.

[8] As noted in footnote 2 above, insurers have differing definitions of corporate business and, therefore, the indicated market shares may not be entirely accurate reflections of relative market shares.

[35] Zurich and Etana are relatively new entrants and thus no information is available pre 2008. It is noted that Zurich has attained a significant market share in a very short period (i.e. nine months of trade in 2008). There is no reason to doubt that it would maintain this market position in future.

[36] In its recommendation to the Tribunal the Commission accepts that the market share of the merged entity will post merger significantly decrease as a result of a reduced book. The Commission in this regard relies on a Santam board briefing note proposing the merger to the Santam Board[9] which indicates that Santam plans to reduce the Emerald book by [...]%, which according to the Commission would reduce the merged entity's combined market share by circa [0-10]%. The Commission also avers that the combined entity's underwriting capacity (and therefore GPW) would in any event not equal that of a separate Emerald and Santam due to a drop in reinsurance that reinsurers would extend to the merged entity.

[37] Not only is the Tribunal highly sceptical of this predicted post merger decline in the merged entity's market share, but also notes that it is a short term point of view which is inappropriate in a merger context. There is no reason not to believe that the merged entity's market share may even increase post merger, depending *inter alia* on the effectiveness of the proposed merger's implementation.

[38] In regard to shared accounts, Matthew testified that "*we* [Santam and Emerald] *have a pretty low clash in terms of common accounts that are going to impact that downscaling of capacity*". The accounts that Santam and Emerald have a common line on are limited to circa 15 accounts, according to Matthew. This was corroborated by Corke who confirmed that Emerald and Santam in fact have only 13 common clients between them (out of a total of circa [...] Emerald clients). Corke attributed this relatively small number of common accounts to relative differences between Emerald and Santam in their risk selection criteria and the manner in which they reinsure. This very limited overlap in terms of shared accounts does not support aversions of a significant post merger decline in the merged entity's market share.

[9] Board Meeting of 27 May 2009.

[39] Furthermore, Matthew affirmed that the merged entity would look to make up any lost market share as a result of shared business and practices around risk management by utilising facultative reinsurance, to the extent that it is obtainable. In regard to reinsurance, the South African Insurance Association (SAIA) expressed the view that the merged entity may because of its larger size post merger have the ability to negotiate better pricing for reinsurance. The merging parties further submit that a Santam/Emerald union would give Emerald access to sufficient solvency capital "*to write more risk*". This defies any factual basis for any assumed significant post merger decline in the merged entity's market share.

[40] From a geographic market perspective, it is noted that the market share of the merged entity (as shown in **Table 1** above) would dilute very significantly if short term corporate insurance placed offshore is considered. The merging parties estimate that approximately 40% of this insurance is placed offshore, *inter alia* through the use by larger corporates of cell captives placed globally.

New entry and entry barriers

[41] According to the Commission's market investigation the barriers to entry into the short term corporate insurance market are significant and can be summarised as:

(i) existing legal (sector regulatory) barriers and proposed new FSB solvency criteria which may place even further pressure on the smaller players;

(ii) considering the size and severity of corporate risks, sufficiently large capital in order to maintain solvency and financial stability levels;

(iii) large corporate clients' requirement that an insurer should have a high rating level, i.e. an 'AAA' or 'AA' rating. Reinsurers would also have an interest in an insurer's rating insofar as treaty capacity is extended to an insurer;

(iv) critical mass to obtain a sufficiently large and diversified portfolio across various sectors, countries and clients to spread out risks and generate sufficient premium income to offset losses. Mass affords negotiating power for reinsurance;

(v) a reputation for specialized corporate underwriting skills (which are in scarce supply), including risk assessment and management skills (for example technical engineering skills to evaluate client risks), as well as a track record that would satisfy brokers that business can be safely entrusted to them, i.e. "broker trust". Matthew in regard to skills and capacity testified that the "*ability of new players to enter the market is certainly one that is driven by the perception of having the right underwriting skill and being able to access capacity, be that from your parent company or your parent underwriter*"; and

(vi) the ability to obtain competitively priced reinsurance. Extending treaty reinsurance carries risks for the reinsurer and they would generally, particularly in the anticipated hard market conditions, need to be satisfied of the appropriateness of the insurer's underwriting philosophy, their approach to risk management and most importantly the skills and reputation of those who will write to the treaty (which further reinforces the above-mentioned skill requirement).

[42] However, despite the apparent high barriers to entry at least two new firms have entered the short term corporate insurance market, namely Zurich and Etana (part of Hollard Insurance). Matthew also cited ACE as a new entrant in the past three years. The Commission however warned that current market conditions and future capital adequacy requirements may depress future entry. SAIA indicated to the Commission that it sees the future prospects of smaller insurers as very tough (given new solvency regimes and difficulties to access capital). The Commission also pointed out that a number of large international insurers that entered South Africa have exited relatively quickly, for example Winterthur, St Paul and XL.

[43] On the other hand, ABSA and RMB, given their access to capital, are more hopeful prospects of additional competition specifically in a follow market. In this regard Matthew testified that RMB, with the support of ex-Swiss Rhee staff, is in the process of setting up an underwriting business that would have "*a minimum*

of R150 million worth of capacity as a start-up". The Commission's market enquiries also confirm that ABSA has been hiring corporate underwriters in the market (including former Emerald underwriters). Matthew however conceded that the likes of new entrants such as RMB and ABSA would be "*more conservative and follow".* Be that as it may, both said players appear to be (potential) new entrants that would provide additional follow capacity.

Alleged reduced capacity/loss of innovative approach

[44] The apparent key to Emerald's perceived innovative underwriting model is the use of a layered reinsurance programme (which makes extensive use of layers of facultative reinsurance in the primary liability layers), very low retention of risks for its own account and the use of treaty reinsurance only once available facultative reinsurance has been exhausted. Thus, on any loss occurring only a very small portion would be borne by Emerald, since most loss would be passed on to the facultative reinsurers and the treaty reinsurance would also be protected.

[45] Certain market participants indicated that if the removal of Emerald eliminated its style of underwriting from the market, that this would be less than desirable. Others again held the view that if Emerald was not transferred to Santam that Emerald's innovative approach would certainly be lost to the market.

[46] As already indicated in paragraph 12 above, any concerns regarding the loss of Emerald's innovative approach following the merger appear to be unfounded and this will not be discussed any further. Furthermore, Matthew testified that even in the event of the transaction not proceeding "*we may well equally consider other options in terms of replicating some of the learnings that we have picked up in terms of doing business on a similar basis to that of Emerald and hence compete in that business model going forward*". Therefore, concerns that Emerald's business model cannot be replicated by other market participants appear to be a red herring; there is no factual basis whatsoever for this assertion.

[47] Regarding the issue of capacity, the Commission concludes that if the proposed merger was not effected (if Emerald was for example liquidated), that this would result in a loss of corporate underwriting capacity driven by a drop in reinsurance extended to the local market. It is alleged that reinsurers would be cautious in extending capacity to new entrants. On the other hand, certain market participants expressed the view that underwriting capacity will in any event reduce post merger, because reinsurers will be unwilling to extend the new entity the reinsurance of its constituent parts.

[48] Corke in his testimony fervently refuted the notion that a prohibited deal would have a significant impact on market capacity. He stated "*anybody has access to international reinsurance*"; "[w]*hether a number of other entrants want to continue to reinsure locally or overseas is a matter of their choice and even since these talks ... one or two other competitors have already moved into our market space and one or two of them will use overseas reinsurance. So, I don't see that as a barrier to this deal being accepted or not accepted. I think it is largely irrelevant*"; "*if ... we [Emerald] went away tomorrow, Everest Tree would come over here and market and try and give one of the new entrants some capacity*"; and "... *if we were to float away tomorrow, other people would move into that market space and take advantage of the other supply channels*". Matthew furthermore contended that "*one of the rationales for the transaction also rests in combining and putting a book of business together that actually has a more attractive combined effect for reinsurers ...".* Therefore, no factual basis exists to conclude, either absent or with the proposed deal, that reinsurance extended (and thus underwriting capacity of the insurers) would significantly be impacted.

Failing firm

[49] Emerald's current financial situation (driven by same of Super Group) and the chain of events that have led to its current sector-regulatory predicament represent a central theme in the Commission's analysis of this case, as well as during the hearing of oral evidence. In the sections below we give a detailed account of the failing firm issue in the context of the proposed deal and the high burden of proof required (from merging parties) to credibly invoke such claim.

Commission's view

[50] Despite established Tribunal and international precedent[10] that the onus is on the merging firms[11] to provide the evidence necessary to invoke the doctrine of the failing firm, in this case curiously it was not the merging parties who invoked this argument but the Commission.

[51] As stated in paragraph 5 above, the Commission recommended an approval of the proposed transaction based *inter alia* on its finding that Emerald meets all requirements of a 'failing firm'. It is pointed out that this argument does not extend to EUM (also see paragraph 69 below). However, information requested by the Tribunal from the merging parties (after the Commission had submitted its recommendation but before the hearing) revealed that the Commission had not been informed by the merging parties of an alternative bidder for Emerald/EUM. Consequently, the Commission (at the Tribunal hearing stage of the matter) based on this new evidence, altered its former stance and concluded that Emerald does not meet the failing firm test. We shall elaborate on the aspect of an alternative purchaser in more detail below (see paragraphs 66 to 71 below).

Tribunal's assessment

[52] The failing firm doctrine enjoys express statutory recognition in the Competition Act, 1998 (Act No. 89 of 1998) (the "Act"). Section 12A(2)(g) of the Act directs us to consider "*whether the business or part of the business of a party to the merger or proposed merger has failed or is likely to fail*" as part of a non-exhaustive list of factors that must be considered in merger assessment. As pointed out by the Tribunal in the merger between Iscor Limited and Saldanha Steel (Pty) Ltd the failing firm doctrine, as such, in the Act is not a 'defence' to a merger that has been found on an initial market analysis to be anticompetitive. Rather, it is recognised as one of a non-exhaustive list of factors that must be

[10] See case no. 67/LM/Dec01, paragraph 110.

[11] As comparison: the burden of proof for invoking the failing firm doctrine rests with the merging parties according to the jurisprudence of *inter alia* the United States of America; this is also the position adopted by the European Union in its Horizontal Merger Guidelines (2004/ C31/03).

taken into account before one can determine whether or not a particular merger is likely to substantially prevent or lessen competition.[12]

[53] In times of financial and economic distress, such as we are currently experiencing, many firms could find themselves in some sort of financial difficulty and these firms may seek to safeguard their long-term survival possibly by merging with (healthier) competitors. The task of the competition authorities is to assess whether the claim that a firm has failed or is likely to fail is genuine or a contrivance to obtain approval for an otherwise anticompetitive merger.

[54] The failing firm doctrine is internationally recognised in competition law jurisprudence and, although not applied uniformly in all jurisdictions, has nevertheless been applied with a considerable degree of uniformity regarding the salient criteria for a credible failing firm claim. Satisfaction is required of each of the following criteria, namely that:

(i) the firm is a failing one;

(ii) the reorganisation of the alleged failing firm is not a realistic option; and

(iii) a less anticompetitive outcome than the proposed transaction is absent.

[55] The Tribunal in the above-mentioned *Iscor - Saldanha Steel* matter held that the merger criteria for a failing firm as set out in the tests of other jurisdictions will carry serious weight in our assessment.[13] It is thus incumbent upon the Tribunal to examine each of the above-mentioned criteria commonly used in assessing the salience of a credible failing firm finding, and we do this in the following paragraphs.

Likely firm failure

[56] Tribunal jurisprudence highlights the fact that it is not necessary in terms of the Act to show that a firm has already failed (as required in some other jurisdictions); failure also need not equate to insolvency. Evidence is required to

[12] *Idem* footnote 10, paragraph 101.
[13] *Idem* footnote 10, paragraph 110.

substantiate *likely* failure.[14] However, likely failure is a complex factual analysis and amounts to showing much more than a degree of financial distress. A common standard found in other jurisdictions is that the alleged failing firm must prove that it would be "*unable to meet its financial obligations in the near future*".[15]

[57] It is stressed that a strict evidentiary approach to likely firm failure is entirely justified given the alleged failing firm's distinct and substantial incentive to establish the semblance of a failing firm in order to alleviate competition authorities' opposition to an ordinarily anticompetitive merger. Such illusion can be created *inter alia* by creative accounting methods and therefore proper scrutiny, on a case-by-case basis, is required of the true financial position of the alleged failing firm, regardless of the type of industry in question and regardless of whether or not that industry is subject to sector-specific regulation.

[58] Counsel for Super Group at the hearing conceded that "*technical insolvency*" is not an obvious "*failing firm scenario*". However, the Commission concluded that Emerald is a failing firm based in the main on the fact that it has for some time not met the FSB's minimum regulatory requirements. More specifically, Emerald no longer complies with a minimum (local) solvency level of 15% and is therefore considered by the FSB to be technically insolvent. The FSB calculates solvency as the firm's net written premiums as a percentage of its "qualifying"[16] net asset value. It is important to note that Emerald's actual audited financial statements thus differ from its statutory balance sheet for FSB regulatory purposes (also see paragraphs 60 and 61 below).

[59] As stated in paragraph 56 above, the likely failure of a firm is a question of fact and as such one would have expected the Commission to perform its own analysis of the financial position and comparative market performance of Emerald before reaching its ultimate conclusion that Emerald is likely to fail. This

---

[14] *Idem* footnote 10, paragraph 109.

[15] See, for example, the *1997 Horizontal Merger Guidelines* published by the USA Department of Justice and the Federal Trade Commission, as well as the *Merger Guidelines* of the Office of Fair Trading of the United Kingdom.

[16] The FSB excludes certain "non-qualifying" assets as per the company's balance sheet from this net asset value calculation.

analysis could have related to *inter alia* (i) Emerald's financial documents such as balance sheets, income statements and cash flow statements; (ii) Emerald's past and recent performance compared to other market participants; (iii) the level of investment required in Emerald to address the solvency and other regulatory requirements; (iv) Emerald's relationships with creditors; and (v) Emerald's access to internal funds and external capital.

[60] From a competition law perspective it is entirely proper to broaden this analysis to the root causes of Emerald's sector-regulatory difficulties, including the identification and analysis of the differences between Emerald's actual and regulatory balance sheet. Corke during his testimony summarised the fundamental causes of Emerald's credit rating downgrade by Global Credit Rating (GCR) and solvency issues as follows: (i) "stripped capital" in the form of paid dividends; (ii) a very substantial inter-company loan to Super Group, of which only 2.5% is recognised by the FSB for solvency purposes; and (iii) a large amount of FSB "non-approved" reinsurance which is not an admitted asset for FSB regulatory purposes[17] (also see paragraph 21 above).

[61] Emerald's latest available financial statements confirm these facts and attributes its lack of compliance with the FSB's capital requirements and solvency ratios mainly to the treatment of outstanding loss reserves on foreign reinsurance in the regulatory balance sheet where the aforementioned is disallowed in terms of STIA.[18] Other factors that contribute to the shortfall in Emerald's regulatory qualifying assets include a very substantial inter-company loan to Super Group and an investment in a subsidiary.[19] It is noted that the settlement of these amounts owed by Super Group to Emerald in any event is a prerequisite of the proposed deal, as confirmed by Corke.

[62] An initial analysis of Emerald's financial statements for the years ended 30 June 2008 and 2009 reveals the following results:

[17] Section 29 of the STIA relates to the aggregate value of assets held and section 30 to the kinds and spreads of assets.
[18] Emerald financial statements for the year ended 30 June 2009.
[19] Letter of 15 January 2009 from Emerald to the FSB.

- dividends of approximately R[...] million were paid during the 2008 financial year. Corke in fact testified that "*two dividends had been taken out of Emerald Insurance Company in the last four years*";
- on 30 June 2009 total assets exceed total liabilities by approximately R[...] million. Not surprisingly, Corke testified that *"[i]f it weren't for the terms of the Insurance Act, etc, I would have every confidence that the assets of Emerald Insurance Company would exceed its liabilities*";
- assets on 30 June 2009 include amounts owing by group companies (loans and receivables) to the value of approximately R[...] million;
- profit after tax amounts to approximately R[...] million in the 2009 financial year;
- cash and cash equivalents at the end of the 2009 financial year are approximately R[...] million; and
- gross premiums increased by [...]% from 2008 to 2009 (approximately R[...] million for the year ended 30 June 2009 and R[...] million for 2008).

[63] The above results speak for themselves and certainly, at face value, are not indicative of a likely commercially failing Emerald. In fact, no compelling evidence of a financial nature has been adduced by the merging parties (or the Commission) that Emerald is likely to fail. The available evidence rather suggests that the precarious position that Emerald finds itself in today is not of its direct own making, but rather a consequence of Super Group's by now common cause financial difficulties. Emerald's immediate and longer-term future it seems depends entirely upon Super Group's commitment to protect Emerald's compliance with regulatory requirements - and it is noted that the Super Group Board in correspondence with the FSB in no uncertain terms articulates this commitment and support to Emerald.[20]

[64] Furthermore, Mr. Gerald Kennedy of Super Group provided a noteworthy summary of the prevailing circumstances surrounding Emerald and its potential recapitalisation at the hearing: "... *there is a possibility that we can recapitalise the group, but from a Board perspective the group has decided to exit its non-core operations. It hasn't contemplated refinancing Emerald Insurance*

[20] Letter from Super Group to the FSB dated 24 March 2009.

Company under its recapitalisation program with financiers. So, at this stage ... it's still not off the table. The door is not closed on that ...". From this submission it is evident that Super Group does not lack the ability but rather the inclination to recapitalise Emerald and to have done so in a timely fashion. This has resulted in Emerald's spiralled lower regulatory solvency levels to its current "technical insolvency". The fact that Emerald at the time of the hearing "*does not have sufficient time left to it to salvage its business*", as submitted by the merging parties, seems entirely of Super Group's making and should therefore be treated with scepticism (also see paragraphs 72 to 77 below that deal with the issue of the potential reorganisation of Emerald).

[65] We conclude that there is no factual basis to conclude that Emerald is either failing or likely to fail.

Alternative offer(s) for target firm(s)

[66] The next issue that we shall examine, on the assumption that the firm in question is indeed likely to fail, is whether or not there is an alternative buyer whose purchase of the target firm(s) would raise less competition concerns than the transaction under scrutiny. For a successful failing firm contention, the merging parties must show that there is no less anticompetitive purchaser than the acquiring firm. The Tribunal jurisprudence[21] is unequivocal regarding the fact that no leniency would be afforded to this requirement, and we strongly reiterate that here.

[67] In the above context the assumed failing firm must demonstrate *inter alia* that it has made reasonable and verifiable good faith attempts to elicit reasonable[22] alternative offers and, furthermore, that there is no viable alternative purchaser that poses less anticompetitive risk than does the proposed transaction.

[21] *Idem* footnote 10, paragraph 110.

[22] In terms of the USA Horizontal Merger Guidelines (1997) any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets will be regarded as a reasonable alternative.

[68] The instant evidence is clear on the score that the target firms have indeed endeavoured to locate alternative buyers. Emerald confirmed that it approached *inter alia* Santam, Zurich Re, Gallagher and Capital Worx regarding Emerald's disposal. Emerald board minutes[23] also confirm that "*the company had been approached by many insurers with expression of interest*." Furthermore, Capital Worx, a venture capital company, made a formal offer for 100% of the equity in Emerald. Moreover, the latter deal would give rise to fewer, if any, likely competitive concerns since the acquiring parties would be a new entrant in the relevant market, according to the potential purchaser (and confirmed by Corke during his testimony). Corke also confirmed that the Capital Worx written offer was "*identical in actual fact, I think*" to the Santam price, but that "*[w]e as a management team turned it down ...*".

[69] It is noted that a less anticompetitive alternative may also include the counterfactual scenario where Emerald is allowed to fail and exit the relevant market(s) and some or all of its assets are transferred to new or incumbent firms. In the instant case there is no reason to believe that incumbent firms in the market or potential new competitors would not be interested in some of the assets of the target firms, more specifically in the ERT (t/a EUM) assets, to be precise the intellectual capital. Corke confirmed that "*the goodwill element of the purchase price is in the Emerald Risk Transfer element of the business*". Furthermore, Matthew testified that in the event of the current acquisition of both Emerald and ERT not being approved, that Santam would consider a deal with ERT "*on the basis that Santam is the insurance licence*". Corke further confirmed that ERT had indeed been approached by Zurich, Investec and ABSA, but that "*management had agreed to sell the 62% [of their shares in ERT] to Santam*".

[70] Furthermore, there is no reason to believe that if Emerald were allowed to fail and exit the market that Santam would in effect gain Emerald's entire market share. In the latter scenario the factual and counterfactual would thus not produce the same resultant market structure, since the intellectual capital of ERT may divert to one or more other industry participant.

[23] Minutes of 01 June 2009.

[71] Nor even if Emerald were to fail, which we do not accept would have been likely to happen, would there be systemic harm regarding the anticipated effect on policyholders with potential claims. Corke in this regard testified that in the event of the proposed acquisition not proceeding that "... *most of the claims will be met, if not all. ... I think the reinsurers will still back Emerald Insurance Company. It won't be them running away ... it's my belief that EIC will eventually meet all these payments* ...". In this context it is important to note that Emerald cedes reinsurance in the normal course of business for the purpose of limiting its net loss potential through the diversification of its risks. Its policies for mitigating risk exposure include the use of both facultative and treaty reinsurance against insurance risks. Thus, the reinsurance agreements spread the risk and minimise the effect of losses (also see paragraphs 18 to 21, as well as paragraph 44 above).

Reorganisation of target firm(s)

[72] The next issue to consider is whether or not any realistic prospect exists for Emerald's successful reorganisation to address its alleged failure and enable it to survive as a meaningful competitor in the relevant market(s). That is, is there any prospect of Emerald surviving as a stand-alone player without the merger?

[73] In a letter addressed to the Tribunal as recent as 12 October 2009 the CFO of Super Group states:

> "*we have since the 24 March 2009 in our attached letter indicated that Super Group will resolve to adequately meet its obligations as agreed with the FSB. To this end the Group has numerous options available to it, including but not limited to a recapitalization, the implementation of a reinsurance program, to run-off the existing insurance portfolio and/or to resume negotiations with other interested parties. To this extent it must also be borne in mind that the Group EIC is a 40% shareholder in Emerald Underwriting Managers, an operation that will more than likely continue into the near future. Further to this the conclusion of Super Group's rights issue as announced in the media, will place the Group in a financially stable position.*"

[74] Furthermore, nowhere in this letter of said date is it suggested that Emerald is a failing or likely failing firm, which supports our finding regarding Emerald's unlikely failure (see paragraphs 56 to 65 above).

[75] Based on the abovementioned Super Group submissions, as well as the submissions of Mr. Gerald Kennedy of Super Group at the hearing (see paragraph 64 above), the real prospect of successfully reorganising Emerald cannot be disputed.

[76] In summary, we found no evidence in support of a valid failing firm argument in this case. First, there is no evidentiary basis to conclude that Emerald is likely to fail despite its difficulties brought about by Super Group's financial situation. Second, an alternative purchaser has made a reasonable offer for Emerald as a going concern and this deal would highly unlikely give rise to any competition concerns. Third, Super Group has submitted documentary evidence that unambiguously state that Emerald could be successfully reorganised absent the proposed deal.

[77] The Tribunal notes its discontentment with Super Group/Emerald for two reasons: first, the non-disclosure of a material fact to the Commission, namely that an alternative offer was made for the target firm(s); and second, the frankly non-credible attempt to rely on the failing firm doctrine "*as an alternative*" toward the end of the hearing into this matter "*because it is out there*", whilst it had neither been claimed prior to the hearing nor any attempt made to produce the required evidence to meet the merging parties' requisite burden of proof.

Removal of an effective competitor

[78] The Commission reaches two seemingly conflicting conclusions in this case, namely that (i) the proposed deal would result in the removal of Emerald as an effective competitor, and (ii) Emerald is a failing company or likely to fail (see paragraphs 56 to 65 above). The Commission gives a historic account of Emerald as an aggressive, growth orientated, flexible, entrepreneurial and innovative insurer, as well as an effective competitor. Third parties contacted by the Commission were however of split opinion on the wisdom of Emerald's

underwriting approach, i.e. if Emerald's growth is as a result of a reckless and unsustainable underwriting model or a truly innovative approach. The merging parties, on the other hand, allege that Emerald is no longer an effective competitor given that it is "*hamstrung"* because of impaired capital requirements and solvency ratios.

[79] There is no dispute between the Commission and the merging parties regarding Emerald's numerous said attributes, except for the latter, i.e. opposing views regarding Emerald's effectiveness. The Commission's investigation had however indicated that Emerald has lost some effectiveness in the immediate recent months due mainly to Super Group's publicly quoted financial issues (also see paragraph 63 above).

[80] The merging parties argue that the fact that Emerald's lack of meeting mandatory capital/solvency requirements may be of its own making, which they do not concede, is of no relevance in this merger context and do not make them less compelling to Emerald's recent lack of competitiveness. The Tribunal is however of the view that the actions of Super Group/Emerald are extremely pertinent in light of the fact that they have every inducement to present Emerald as an ineffective competitor in order to gain approval for a potentially anticompetitive deal. Very recent claims of ineffectiveness, as alluded to in this case, must be thoroughly interrogated, especially when they appear to be generated or caused by the actions, or lack of actions as the case may be, of a parent company (Super Group) and its strategy, rather than on the true market perception of Emerald's competitive significance.

[81] We stress that the issue of the effectiveness of Emerald (or recent ineffectiveness as argued by the merging parties) cannot be severed from the factors considered in the alleged failing firm analysis, specifically the fundamental causes of Emerald's current sector-regulatory predicament, including the role of Super Group in that. Having said this, it is by no means suggested that the issue of sufficient capital to meet statutory solvency requirements is not a relevant one in the context of this transaction and this relevant market. The factual and perceived financial position of an insurer in this relevant market is highly relevant, but in a merger regime context this must be

evaluated in the context of the fundamental causes of any such (recent) perception and the potential remedies thereof. As concluded in paragraph 75 above, there can be no doubt in the instant matter of the realistic option of successfully reorganising Emerald, given Super Group's recorded commitments to the FSB in this regard. Moreover, this option was reiterated in a very recent communiqué of the merging parties to the Tribunal (see paragraph 73 above).

[82] Furthermore, although it is reasonably plausible that a truly failing firm could not attain qualification as an effective competitor, Emerald (as concluded above) is by no stretch of the imagination a commercially failing firm (see paragraphs 56 to 65 above). It is noteworthy that Santam's board briefing document on the merger supports the notion of a commercially highly successful Emerald, despite certain capital constraints: "*EIC has reflected massive premium growth, limited only due to its capital constraints. Gross Written Premium ("GWP") for the [...] to February 2009 was greater than the GWP for the [...] preceding it, and the book has grown by almost [...]% since 2007*".

[83] In light of the above, the Tribunal is highly sceptical of the merging parties' extremely short term perspective of Emerald's alleged ineffectiveness. Corke's testimony by no means points to Emerald's pivotal reputational impairment. To the contrary, he testified that even under the current conditions the brokers "*have shown faith and confidence*" and generally have been supportive of Emerald/EUM.

[84] Based on the above, we have no firm basis on which to conclude that Emerald is not an effective competitor in the short term corporate insurance sector, given *inter alia* the realistic possibility of its successful restructuring (according to the merging parties own documents). On the premise that Emerald is an effective competitor in the overall short term corporate insurance industry, the question that remains is if Emerald is also a credible and therefore effective competitor in a potential lead market. This is discussed below (see paragraphs 91 to 100).

Countervailing power

[85] Most of the larger corporates have risk officers or insurance managers with insurance knowledge who coordinate and manage their insurance. Furthermore, the short term corporate insurance industry is almost entirely intermediated through large corporate insurance brokers, for example Glenrand M-I-B, Alexander Forbes, Aon, Marsh and Willis, who are in many cases local subsidiaries/branches of international corporate insurance brokers (for example Willis, Aon and Marsh). Corke described this relationship between the risk manager and broker as follows: "*the risk manager would habitually go in South Africa to one of five broking houses ... and with the broker at that broking house they would make the decisions of how they wanted the insurance placed*".

[86] These appointed brokers would generally on an annual basis seek quotes from insurers and then negotiate terms with selected insurers. In the case of coinsurance contracts such negotiations would generally be conducted with their preferred lead insurer. Negotiations appear generally to proceed around broker terms (with the large brokerages having their own precedents/standard terms) rather than any standard insurer produced wording (also see paragraph 23 above).

[87] The Commission concluded that the size of the large corporate brokers, their expertise, and in the case of some of the international corporate brokers their international scope, may provide some degree of countervailing power to a customer. However, the Commission provided no examples of situations in which this alleged customer countervailing power had been effectively exercised. The Commission in its recommendation also suggests that there may be current corporate skill scarcities amongst brokers that may negate this power. We therefore conclude that there may be some element of customer countervailing power, but that it has not been satisfactorily established.

Conclusion

Overall short term corporate insurance market and potential follow market

[88] Although the merged entity would be the largest player post merger in the South African overall short term corporate insurance market, various competitors remain active in that market post merger. The Commission's market

investigation and witness testimony confirmed that AIG and M&F are the largest competitors to the merged entity in terms of capacity in an overall national market for short term corporate insurance. M&F has a market share exceeding 20% in this market and AIG has a market share exceeding 10%. Furthermore, there is a competitive fringe of at least five smaller competitors. Etana, Zurich, Lion of Africa and to a lesser extent ACE were identified in the Commission's market investigation as predominantly participants in the follow market. Customers also confirmed that there are a sufficient number of smaller players that can put down follow capacity. Furthermore, two potential new entrants in the follow market have been identified, namely ABSA and RMB. This alleviates any likely unilateral or co-ordinated post merger competition concerns in a potential follow market.

[89] Furthermore, the proposed merger would not alter certain market dynamics, for example (i) well advised clients that make use of large brokerages who may have a degree of countervailing power; (ii) annual insurance contracts with low or insignificant switching costs (penalties only apply if contracts are terminated midterm and if there was a claim); and (iii) innovative approaches and differentiated offerings by market participants to limit their risks as far as possible.

[90] Based on the above, no significant competition concerns arise as a result of the proposed deal in the overall market for short term corporate insurance and in the possible narrower follow market. The potential lead market is discussed below.

Potential lead market

[91] From witness testimony it is blatantly evident that the lead insurance provider sets the terms and conditions for short term corporate insurance. Corke articulated the significance of the role of the lead in coinsurance arrangements as follows: "... *the broker and the risk manager will come up with a strategy as to what their preferred lead is, what the terms of the contract are, because the lead office will set the contract terms... The broker would then go to the market, the*

coinsurance market ... and say these are the lead terms ... on this particular risk, would you be interested in participating?".

[92] Corke furthermore confirmed that the lead constantly sets the insurance price. He testified that in his experience the lead sets the price in "99% of business" and all other insurers will be on the same pricing schedule (excluding a 2.5% (contract) handling charge by the lead office). He further stated: "*I don't think there is one [of circa [...] clients] where our [Emerald's] price is below what the lead price was* ... *it's never in our interest to be seen as somebody who cuts the price, because our share would be a lesser price*". He also testified that there were only four or five accounts on which Emerald as co-insurer achieved a higher price than the lead. He further confirmed that pricing is usually driven by the pricing for reinsurance capacity. In fact, the price of short term corporate insurance is a derivative of the costs of *inter alia* reinsurance and capital. As pointed out in paragraph 19 above, the price of reinsurance is largely determined by factors external to the control of the primary insurer.

[93] As stated in paragraph 26 above, while the available evidence does not suggest a rigid division between players in lead and follow positions, there does appear to be a very small group of players who dominate the lead market. According to the Commission, competitors and brokers alike agree that Santam and AIG are the most significant leads, followed by M&F. Furthermore, as indicated in paragraph 43 above, Matthew conceded that new entry into a potential lead market is unlikely. He explained that the ability to take lead positions "*is based on credibility and relationships with brokers as well as your clients in the market and for a new entrant to come in and form a leadership position is very unlikely ...*".

[94] Although Emerald is generally regarded as a predominantly follow insurer, the Commission however received mixed information on whether Emerald could be characterised as a credible lead (also see paragraph 24 above). Matthew conceded that Emerald is a good example of an entrant that geared up from being a follow capacity provider to "*at least competing with some of the lead markets*". He however was of the view that the brokers still prefer the traditional

lead companies, i.e. Santam, AIG and M&F, for the security that they provide to clients to meet future obligations.

[95] From the depicted market structure, pricing practice, entry barriers and other facts relating to this case it is clear that the salient hypothetical theory of harm is potential adverse (unilateral) competition effects in a potential lead market. In this potential market there would be only three significant players post merger, namely Santam/Emerald, AIG and M&F. However, for the reason stated in paragraph 24 above, the Commission did not focus its attention on this potential market. As a result, neither has such market been properly defined by the Commission as a separate relevant market, nor satisfactory qualitative and quantitative evidence provided on the likely competitive effects of this deal on this potential market.

[96] To contextualise Emerald's actual lead positions, Corke stated that out of the 13 common accounts between Emerald and Santam (see paragraph 38 above), Emerald has the lead of none of them. He further testified that Emerald has very few lead policies on its books and in his view is not perceived as a "*credible lead*" - it is the lead of less than 10% of its portfolio. The reason for this according to Corke is that: "*whilst ... our market reputation means that we* [Emerald] *have the intellectual capacity to be the lead, I don't think many people think we've got the balance sheet to be the lead ... Super Group was never perceived as a financial service provider ... part of our strategy ... was to be a second lead, in other words, have a big chunk of the programmes that we wanted ... it's easier for a broker to sell the Emerald brand as a second lead than as a major lead ... we were seen as a capacity provider ... as somebody who could come up with solutions and back it up with reinsurance*".

[97] Corke further testified that Emerald and Santam differ in the manner in which they segment capacity. He explained the latter comparative difference as follows: Emerald has the ability to book only a R300 million line, compared to Santam who can book a R750 million line. This implies that on a portfolio of R1.5 billion, Santam could book 50% down, but Emerald only 20%. This suggests that portfolio size could be a significant factor in assessing lead credibility.

Unfortunately brokers have in this case not submitted comparable figures to the Commission regarding the relative size of the risk/contract, i.e. some submitted premium information, others insured sum information, and others no information on the relative size of the risk/contract (also see paragraph 100 below).

[98] The Tribunal analysed the available quantitative information on lead contacts as submitted to the Commission by various brokerages. Our analysis confirms that AIG and Santam indeed are the main leads. M&F also has a number of substantial lead contracts. However, the available data suggest that not only Emerald but a number of smaller players in the industry, including Zurich, ACE, Lion of Africa, Allianz and to a lesser extent Etana, from time to time take lead positions, of which some are significant in terms of premium/sum insured.

[99] In conclusion, there is no evidentiary foundation that the proposed merger is likely to substantially prevent or lessen competition in a potential lead market. More specifically, there is no quantitative or other evidentiary support for the aversions that Emerald played a maverick or more significant role than said other smaller players in a potential lead market. Based on the limited and mixed available information we cannot determine with sufficient certainty how the proposed merger would impact the number of credible leads.

[100] A more narrow focus by the Commission on the effects of the proposed deal on a potential lead market, including the characteristics and competitive dynamics thereof, would have placed the evidentiary value of market positions, the views of brokers/customers and other relevant information in context. Broker data on the quotation and selection processes of (preferred) leads in past awarded contracts would have been of more value to establish lead credibility from a customer perspective than the furnished information on actual lead positions post conclusion of these processes. Broker information was namely submitted to the Commission regarding (i) the identity of ultimate lead(s); (ii) the type of risk; and (iii) the sector in question, for example mining, retail or other relevant sector. Meaningful additional data on a per quotation basis would include *inter alia* (i) the broker stipulated criteria/conditions that potential leads have to comply with; (ii) in a comparable format, for example on the basis of sum insured, the relative size of the risk/contract; (iii) the identities of potential leads

who submitted quotes; (iv) the price and other terms and conditions offered by each participant; (v); the manner in which the broker/client in question used this information to ultimately negotiate better terms and conditions with the ultimate lead; and (vi) the broker's criteria for selecting the preferred lead/reason(s) for the final lead selection.

PUBLIC INTEREST

[101] No significant public interest issues arise as a result of the proposed deal.

CONCLUSION

[102] Since there is no evidence of a likely substantial prevention or lessening of competition in any (potential) relevant market as a result of the proposed deal, and also no significant public interest issues arising from this deal, we accordingly approve the transaction without conditions.

____________________ **27 January 2010**

A Wessels Date

N Manoim and A Ndoni concurring.

Tribunal Researcher: I Selaledi

For the merging parties: Cliffe Dekker Hofmeyr Inc

For the Commission: F Reid and M Van Hoven (Mergers & Acquisitions)