Financial Conduct Authority: General insurance pricing practices market study – Consultation on Handbook changes

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Consultation response from the

Centre for Competition Policy

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This consultation response has been drafted by the named academic members of the Centre, who retain responsibility for its content.

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Centre for Competition Policy response to 'General insurance pricing practices market study – Consultation on Handbook changes'

We welcome the opportunity to comment on the FCA's proposals for limiting the pricing behaviour of insurance providers. We fully appreciate distributional issues and are concerned by the current pricing behaviour of insurance providers regarding 'price walking', but we also have concerns that the current proposals have not been thought through regarding their full impact on the market equilibrium. While we wish to see unfair price walking stopped, this needs to be achieved with the least possible undermining of the consumer benefits of competition. Such an approach is entirely in line with the FCA's strategic objective of ensuring that insurance markets function well, and with its operational objectives of consumer protection, market integrity and competition. These three operational objectives need to be in balance.

Rather than responding to the specific questions of the consultation below we provide more general comments.

Transactional fairness and price discrimination

The following comments should be read in the context of our agreement with the view that annual price walking has resulted in insurance prices that are widely considered unfair and so undermine consumers' confidence in the market. One way to think about this is that each customer enters into an implicit contract with their insurance company when taking out insurance, especially when it is likely to renew (by default). What is reasonable for ordinary consumers to expect of their 'trading partner'/insurance company? Transactional fairness requires that a firm acts in such a way that consumers with normal expectations about pricing practices in the relevant market are able to understand the consequences of transacting with that firm (*No Deception*) and are not hindered from terminating a relationship with the firm or from transacting with alternative sellers (*No Hindrance*).[1] In the context of this response, 'no hindrance' fits well with the FCA proposals in relation to auto-renewal. However, more care is needed in relation to what may effectively be deceptive given normal consumer expectations.

It is not a normal expectation in a market economy that all prices will be the same, and it is not inherently unfair for a firm to make low-price introductory offers that are available only to new customers. Such offers are compatible with intentions for mutual benefit between the insurance company and its client if the low price is paid for an introductory period, and *if the intention is to allow new customers to sample the firm's product, or to compensate them for the costs of searching and switching*. It should also be made clear to the consumer that after an introductory period the price will increase. For example, this may be achieved by an explicit introductory discount on a price protected against price walking. Regulation prohibiting all forms of inter-temporal price differentiation becomes problematic if it has the effect of guaranteeing consumers the best offer and this eliminates the incentive for firms to make competitive offers for new customers. The FCA's

[1] For this approach to 'transactional fairness' and what we mean by 'normal expectations', see Lyons and Sugden (2020), 'Transactional fairness and unfair price discrimination in consumer markets', CCP Working Paper 20-07, Centre for Competition Policy, available at: http://competitionpolicy.ac.uk/documents/8158338/31901793/CCP-20-07.pdf/6b0edb46-8135-ac21-441c-f0deff07acc8

proposals appear close to doing this, and it is not clear that the FCA has appropriately considered alternatives, such as the suggestion above of allowing 'discounts' for new customers, while imposing constraints on price walking for further renewals. Such an approach may represent an improved trade-off between the FCA's consumer protection and competition objectives.

The nature of the pricing restraint and its implications

We begin by noting that comparethemarket.com was recently fined £18m by the CMA for its Most-Favoured-Nation (MFN) agreements, including for home insurance. The problem was that the MFNs suppressed competition between Price Comparison Websites (PCWs). The MFNs related to new business across PCWs and so are not directly comparable to the FCA's current proposals, which relate to linking the prices of new and continuing customers of a single insurance company. However, it is unclear from the consultation document whether the FCA's proposals may indirectly have a similar negative effect on competition.

The discussion in this section is based on the text in the final report of the FCA's market study.[2] In this document, the proposed pricing remedy specified by the FCA is:

> *5.4 We propose to require that when a firm offers a home or motor insurance renewal price to a consumer, that renewal price should be no higher than the equivalent new business price the firm offers. This will stop firms from price walking customers.*[3]

It really matters what precisely is meant by this statement. Let P_{it}^{j} be the price to consumer type j for product i at time t, where $j = R, N$ (renewing and new).[4] If the requirement is that: $P_{it}^{R} = P_{it}^{N}$ (the price for a renewing customer of a given product in a given year equals the price for a new customer purchasing the same product in the same year) this is essentially equivalent to the non-discrimination clauses which the Competition and Markets Authority thought acted against effective competition in the retail energy market.[5] Whether such a ban on price differentials is a good idea depends on the type of firms that dominate the insurance industry. If the industry is dominated by firms with large numbers of renewing customers, i.e. a large back book relative to their front book, following the imposition of the price remedy they will likely have an incentive to focus on preserving the high prices of renewing customers previously subject to "price walking" and this will have an adverse effect on competition much like in energy. In other words, they will mainly increase P_{it}^{N} towards P_{it}^{R}, rather than decrease P_{it}^{R} towards P_{it}^{N}. For a discussion of this issue in relation to the energy market see Hviid and

[2] Financial Conduct Authority (2020), 'General insurance pricing practices – Final Report', Market Study MS18/1.3, September 2020

[3] Pg22

[4] While mathematical notation is not to everyone's taste, it does illustrate the complexity of the precise prices being compared. This complexity may represent a communication challenge for the FCA when explaining to the public what the pricing remedy does and does not allow.

[5] See paragraph 302, pg 71, Competition and Markets Authority (2016), 'Energy market investigation – Summary of final report', 24 June 2016, available at: [Energy market investigation: Summary of final report (publishing.service.gov.uk)]

Waddams Price (2012)[6] and Waddams Price and Zhu (2016)[7]. This issue is also discussed further in the following section.

A further potential complication with the requirement $P_{it}^{R} = P_{it}^{N}$ is that in transacting with a given consumer over time an insurance company is gaining information on that consumer. If public information about new customers matches the private information of insurance firms about renewing customers, this is not a problem since the price matching will be across new and renewing customers with equivalent characteristics. However, if insurance firms' private information is superior, it does raise the question of whether it is desirable to limit firms' ability to price according to this information.

Potentially anticipating the incentive for some firms to withdraw from new business, and more generally to deal with closed books, the market study also states:

> *5.5 Where products are not currently sold, our proposed rules set out requirements on identifying close matching products to determine the equivalent new business price. We think it will be rare that a firm is unable to identify a close matching product. However, our proposed rules also set out that firms must not systematically discriminate against their customers by tenure.*[8]

If insurance companies segment the market into risk classes, is it actually straightforward to identify 'closely matching' products? The constraint imposed by the proposal in 5.5 seems to be very powerful, as now the pricing restriction is beginning to expand across multiple product types. Presumably one purpose of the constraint is so that firms cannot game the system by making marginal changes to the product every year to confound price comparisons. For the price remedy to be a credible deterrent to firms there needs to be an effective monitoring mechanism so that breaches of the regulation can be identified and punished. Checking that the full set of prices comply with the constraint seems likely to be an involved and costly process, especially when prices will not only vary by product type but risk class.

> *5.6 Firms will still be able to offer different prices to different consumers. They will also still be able to offer a range of brands and types of products to consumers at different prices and via different channels. This will help to ensure that consumers still have a range of choices in the market. It also means firms can still offer competitive deals to consumers who shop around and switch regularly.*[9]

5.6 seems to imply that for any set of prices other than $P_{it}^{R} = P_{it}^{N}$, there is no restriction on how prices can differ. If this is the case, might we expect to see a proliferation of brands and product types as firms attempt to work around the pricing regulation by continually modifying their product? 5.6 also seems to suggest that we need to add a fourth index, k which indicates the channel of distribution, i.e. the only restriction is $P_{ikt}^{R} = P_{ikt}^{N}$. If this is the case, how much does the remedy's restriction really restrain firms' pricing behaviour?

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[6] Hviid, M. and C. Waddams Price (2012), 'Non-Discrimination Clauses in the Retail Energy Sector', Economic Journal, 122(August), pp. F236-F252

[7] Waddams Price, C. and M. Zhu (2016), 'Non-Discrimination Clauses: Their Effect on British Retail Energy Prices', The Energy Journal, 37(2), pp. 111-132

[8] Pg22

[9] Pg22

Lack of detail on the competitive process
In Annex 2 of the consultation a cost benefit analysis for the proposals is provided. A crucial element in this analysis is how firms respond to the FCA remedy regarding their pricing behaviour. The simulation of the price responses assumes two scenarios[10]: (i) firms adjust premiums so that the expected profit of the average contract remains the same, and (ii) the pricing remedy will lead to greater competition leading to a 20% reduction in profits compared to the baseline.

The consultation document does not appear to justify *why* these are the sensible scenarios to consider. Hence, it appears that the FCA is basing its view that the pricing remedy will improve competition, or at least do no harm, solely on an assumption. There is considerable academic literature showing that when restrictions are placed on price discrimination a wide range of outcomes can result, including those which are anti-competitive and lead to an increase in prices for *all* consumers. As already noted above, a clear example of the potential for negative impacts on competition is provided by the case of Ofgem imposing non-discrimination clauses for the regional pricing of tariffs in the domestic energy market. A review of the economics literature on whether price discrimination is beneficial or harmful for consumers can be found in Townley et al. (2017)[11].

The key feature determining whether price discrimination (and hence banning or restricting it) is pro- or anti-competitive is whether competing firms agree or disagree on the consumers to which they view it as desirable to charge a high price to. In technical terms, whether there is best response symmetry or best response asymmetry. When there is best-response asymmetry, i.e. firms disagree on which consumers warrant high prices, price discrimination should lower prices (and banning it raise prices). In contrast, when there is best-response symmetry, i.e. firms agree on the consumers which warrant high prices, price discrimination is likely to raise prices (and banning it lower prices). It seems important for the FCA to confirm (and explain) that the nature of the market adheres to a situation where restricting price discrimination is beneficial, before implementing the remedy. If there is likely to be a trade-off between competition and distributional concerns it is important the FCA is open about this.

Product Governance
In broad terms we are supportive of the proposal that providers and intermediaries have to consider whether their products offer fair value to consumers. This provision also accords with the concept of 'Transactional Fairness' proposed by Bruce Lyons and Bob Sugden[12]. The proposal should further reinforce efforts to avoid a repeat of the PPI scandal. It is positive that the proposal applies to intermediaries/distributors as well as underlying insurance providers, which should ensure that cases are covered where the issue relates to the pricing practices of the intermediary/distributor rather than the underlying insurance provider.

However, as ever, the devil is likely to be in the detail. It seems likely that the FCA will have to provide further clarity on what it views as being fair or unfair. For example, are classes of products that have a very low claims to premium ratio inherently unfair? Without clarification it seems likely that

[10] See pg38, Financial Conduct Authority, 'General insurance pricing practices market study: Consultation on Handbook changes', Consultation Paper CP20/19, September 2020
[11] See pg688-703, Townley, C., E. Morrison and K. Yeung (2017), 'Big Data and Personalized Price Discrimination in EU Competition Law', Yearbook of European Law, 36(1), pp. 683-748
[12] See Lyons, B. and R. Sugden (2020).

companies may take differing views as to what constitutes 'fair value' including some judgements which the FCA may not currently envision. Where in paragraph 4.12 it states that "we consider certain price optimisation practices would not offer fair value", it is important that the FCA fully considers the detailed economic arguments around price discrimination/price optimisation detailed above to ensure that its decisions regarding which pricing practices to ban do not have undue negative consequences.

Subject to this concern around the clarity of the fair value provision, we support the governance proposals to make an individual senior manager responsible for compliance with the fair value provision as this should hopefully focus minds within firms to ensure the provision is met. This is strengthened by the requirement that a senior manager attests on an annual basis that their firm's product offerings are compliant with the pricing remedy (paragraph 3.20-3.21).

Auto-renewal proposals

We support the proposals to make it easier for consumers to stop the auto-renewal feature of the policies. Steps that increase consumers' awareness of opportunities to switch supplier and remove impediments to doing so are beneficial. In broad terms this can be seen as a step to reduce switching costs and increase engagement which should be beneficial both to consumers and competition.