Pricing Analysis Project Team
Emergency Services Levy Insurance Monitor
Level 18, 1 Margaret St
SYDNEY NSW 2000

By email: consultation@eslinsurancemonitor.nsw.gov.au

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Dear Sir/Madam

PRICING DIFFERENCES: NEW VS EXISTING CUSTOMERS

The Insurance Council of Australia (Insurance Council) is responding to the Discussion Paper "Pricing differences: New vs existing customers" (the Discussion Paper) which the Emergency Services Levy Insurance Monitor (ESLIM) released for public comment on 30 November 2018.

ESLIM's mandate

As can be seen by the general functions of the ESLIM as set out in Section 9 of the *Emergency Services Levy Insurance Monitor Act 2016* (NSW) (the Act), the role of the ESLIM is tied to emergency services levy reform. It is not, as asserted several times in the Discussion Paper, generically "to oversee a regulatory framework for the protection of insurance consumers".[1]

Section 10 of the Act outlines that the ESLIM may monitor insurance prices for either or both of the following purposes:

a) to assess the general effect of the emergency services levy reform on prices charged by insurance companies for regulated contracts of insurance,

b) to assist in the consideration of whether insurance companies are engaging in prohibited conduct. (With prohibited conduct being defined in Section 3 of the Act to mean price exploitation or false or misleading conduct in relation to the emergency services levy reform.)

In seeking to justify the ESLIM's activity in the wider consumer policy sphere, the Discussion Paper conflates price differentiation, price discrimination and price exploitation.[2] However, as the ESLIM would be well aware, price exploitation under the Act is defined in Section 14 through the consideration of factors integral to the implementation of emergency services levy reform.

The Insurance Council and its members do not shy from critical analysis of the general insurance industry. Indeed, as will be detailed later in this submission, we are actively

[1] See, for example, Discussion Paper pages 6 and 8.
[2] Discussion Paper page 9.

engaged in several significant reviews and inquiries. However, the Insurance Council does not see it as a legitimate or even effective use of taxpayer funding for an entity established to oversee the reform (now postponed) of a State tax to research and comment on matters such as competition policy and financial services disclosure when there are national bodies already properly resourced for such purposes.

Research methodology

Insurers provide the ESLIM with data in order for it to monitor the prices of insurance contracts subject to ESL and enable the ESLIM to detect prohibited conduct. Insurance Council members have complied in good faith with all the many detailed data requests made by the ESLIM. Despite this co-operation, the ESLIM undertook its analysis of pricing without consulting the industry as to the methodology or the soundness of its findings. Consequently, the ESLIM has made high profile claims about industry-wide pricing practices based on an incomplete dataset collected for a different purpose.

Furthermore, the methodology adopted by the ESLIM is seriously deficient. The ESLIM seeks to make the point that price discrimination occurs between new and existing customers. As the ESLIM notes in the Discussion Paper, price discrimination occurs when the same product or service is sold to different customer segments at different prices even though the *cost of providing the product or service is the same*. It is therefore surprising that the Discussion Paper fails to include any analysis of the costs faced by insurers. For example, there is no reference to reinsurance, a key cost for insurers in managing their risks.

Similarly, the ESLIM does not adequately take into account the risk profiles of new and existing customers. The ESLIM refers to overly simplistic adjustments using the sum insured value. While sum insured value is an important risk factor, the risk profile of an insured also depends on the likelihood of an adverse event occurring and the statistical distribution of likely payouts. In information economics, individual customers are able to signal their risk type by choosing an excess. On the evidence, new customers are selecting, on average, higher excesses than renewal customers.

In addition, the ESLIM asserts that insurers escalate the sum insured on renewing policies each year, and immediately goes on to state that over-insurance can be a problem for consumers. Any speculation about over-insurance in the market is both unsupported by evidence and reckless. There is, for example, no analysis in the Discussion Paper of increases in the value of the underlying insured asset.

Other factors contributing to differential pricing

Insurers use a variety of pricing methods that are commonplace in many industries in Australia and internationally to help determine what a company will charge customers for its product or service. Firms across all sectors have long used these pricing methods to help determine prices that are consistent with their strategic goals. Factors that can be influential in setting prices but which are not given appropriate consideration in the Discussion Paper are:

Discount

A common commercial pricing adjustment is to offer new customers a discount either directly online or via an intermediary. These discounts are typically removed on the first renewal or over the first two or three renewals.

Sum insured

Sum insured is a major rating factor used to derive premiums for combined home and contents insurance. It is a significant factor in the modelling by insurers of the risk cost for working claims such as burst pipes, motor fusion, storm, house fires, bushfire and flood. When allocating reinsurance costs, for earthquakes as an example, sum insured is an extremely relevant factor.

Excess

Another major consideration is the customer's choice of excess. A higher excess of course leads to a lower premium. The excesses for new business and renewal customers typically vary which is likely to also contribute to a gap in the premiums. Insurers regularly update default basic excesses offered to new business customers to reflect changes in asset prices, claims inflation and to limit or in some cases prevent a potential premium increase. In this regard, it is likely that the longer tenure renewing policies will on average have lower excesses than new business policies (notwithstanding the customer's ability to choose a lower excess), thus attracting a higher premium on a comparable basis.

Corporate Governance and Ethics

The Discussion Paper refers extensively to research on financial services pricing by the Financial Conduct Authority (FCA) in the UK. In this context, it is worth noting that a recent FCA paper[3] examined the interplay of economic and fairness considerations when assessing price differentiation in financial services. The paper did not find that price differentiation was inherently unfair but identified six key evidential questions to assess the scale of any "distributive fairness" concern.

When these are examined, many of the positions assessed as satisfactorily addressing fairness are aligned with the approaches taken by Australian insurers to price setting and are incorporated within the product development processes of their wider corporate governance frameworks. This has been done by insurers to ensure that the pricing methodology focuses on setting a reasonable price which is not excessive, inadequate or unfairly discriminatory.

Policy dialogues on insurance issues

General insurance is regulated nationally in Australia and as explained earlier, the Insurance Council is playing a key role in a large number of policy dialogues. Amongst the national level entities addressing themes such as pricing, competition and disclosure are:

- the Senate Economic References Committee with its report into Australia's general insurance industry;
- the Productivity Commission's report into Competition in the Australian Financial Systems;
- the three year inquiry by the Australian Competition and Consumer Commission (ACCC) into insurance in northern Australia. Its first interim report released on 18 December 2018 states that, as part of Focus 3 for this inquiry, the ACCC will examine the extent to which insurers are discriminating between new and existing customers through premium adjustments;

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[3] See Figure 3, page 6 of Financial Conduct Authority, *Price Discrimination in financial services: How should we deal with the question of fairness.* Online. July 2018.

- the discussion paper on effective disclosure which Commonwealth Treasury is expected to release shortly in response to the Senate Economic References Committee report;
- the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry which will report on 1 February 2019; and
- the Insurance Council's review of the General Insurance Code of Practice.

A uniform national regulatory regime is vital for the effective operation of Australia's general insurance industry because it avoids policyholders having to shoulder the costs of insurers complying with different State and Territory requirements. It is imperative that the ESLIM allows these processes to take place at the national level, unimpeded by pre-emptive action in relation to NSW. This would allow entities with clear regulatory mandates to implement initiatives with national application and thereby avoid complications arising where policies cover risks in multiple Australian jurisdictions. Co-ordination of reforms is essential in order to minimise implementation costs such as systems changes and training.

If you have any questions or comments in relation to our submission, please contact John Anning, the Insurance Council's General Manager Policy, Regulation Directorate, on (02) 9253 5121 or janning@insurancecouncil.com.au.

Yours sincerely

Robert Whelan
Executive Director & CEO