Which? works for you

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Response to: FCA General insurance pricing practices market study, MS18/1.1 terms of reference

Summary

- Which? welcomes the FCA's market study on general insurance pricing practices. We broadly support the FCA's focus on pricing practices that could harm consumers, the fairness of pricing practices, and impacts on competition.

- The Market Study rightly has a strong focus on inertia pricing, whereby an individual consumer faces different prices depending on whether he/she is a new or long-standing customer. Which? has found evidence of inertia pricing in home insurance that we consider to be unfair as higher prices fall disproportionately on vulnerable consumers. Older customers, in particular, are more likely to have had the same policy for longer, more likely to be more vulnerable, and potentially less able to carry out effective price comparison. The FCA should consider regulation as demand-side remedies are unlikely to be sufficient to address any harm in these cases.

- As well as this, the FCA should consider issues relating to some price optimisation practices, whereby different consumers face different prices according to their individual characteristics and those price differences are beyond those that could be explained by differences in risk and hence the cost of providing insurance. We have found some evidence of price optimisation practices that could be unfair. However, this type of pricing is often difficult to identify, and the scale of the problem is difficult to assess. The FCA should therefore examine insurance firms' pricing models, including the basis of any algorithms, to understand how these practices impact different groups of consumers including via forms of indirect discrimination.

- We support the FCA's focus on the impact of pricing practices on competition and the specific issues it aims to examine. Additionally, we are concerned that some pricing and marketing practices can potentially have a negative impact on competition in general insurance markets. In particular, where firms have developed business models involving the use of multiple brands. This could lead to consumers comparing the prices of different brands while unaware that those brands are owned by the same company. The FCA should explore whether insurers should be required to be more transparent to consumers about the ownership of brands.

Further detail

Q1: Do you have any views about whether pricing practices for home and/or motor insurance may cause harm? If so, please explain how and which consumers this affects.

Which? believes that there are two forms of price discrimination that could exist in general insurance markets and that might cause harm to consumers.

The first is the case in which an individual consumer faces different prices depending on whether he/she is a new or long-standing customer. This is known variously as 'inertia pricing', 'loyalty pricing' or 'dual pricing', although multiple prices may exist depending on the number of years the insurance has been held for.

The second is the case in which different consumers face different prices according to their individual characteristics and where the price differences are beyond those that could be explained by differences in risk and the expected loss ratio for each consumer. This is sometimes known as 'price optimisation', and some cases of this may cause concern.

Although 'inertia' pricing on the basis of propensity to renew could be considered a form of price optimisation, we make a distinction between these in this submission. This is because there exists clear evidence on the existence of inertia pricing, while some type of price optimisation practices such as personalised pricing are more difficult to document and the challenge is to estimate the extent of existing and potential price optimisation practices that could be harming consumers. Further, different remedies would be needed to address harms caused by each of these practices.[1]

Inertia pricing

Which? research supports the FCA's findings in in TR18/4 on differential pricing. Insurers price discriminate according to the length of time with which a customer has held a policy, and higher prices are charged for renewals than for new customers. In home insurance, we found that the longer customers have owned their policy, the greater the disparity between what they pay and what a new customer with the same cover would pay. On average, people who had been with their insurer for more than a year paid £75 more than new customers for combined policies.[2]

Further, our research on who this affects also supports the FCA findings. We found that people who are older have a lower propensity to change insurer and are therefore more likely to pay high renewal prices. Specifically, one in six (16%) of those aged over 75 in our survey had the same policy for more than 10 years, compared to just 5% of those under 45.

Price optimisation

The second instance of price discrimination that might cause harm is where insurers price discriminate according to individual characteristics, such as age, occupation or location. These are legitimate risk rating factors in their own right, and hence expected to affect the price, but which might not be expected to affect the price beyond their impact on the actuarial risk. Those practices may lead to biases or unfair prices. This practice is known elsewhere as price optimisation and has prompted regulatory action in the United States.

[1] We also draw a formal distinction between these types of price discrimination. In the case of inertia pricing, the same consumer potentially faces two prices from a given firm - the price he/she would pay as a new customer and the renewal price. By not shopping around the consumer self-selects (albeit probably unconsciously) into paying the higher price. By contrast, with price optimisation there is only one price that the consumer can receive from each insurer. At the extreme, if all insurers price optimise on the same basis then the entire distribution of market prices shifts and the consumer cannot avoid the discrimination. Even if only some firms use unfair price optimisation the consumer could be worse off as he/she may face a less competitive market than other consumers.
[2] See https://www.which.co.uk/news/2018/08/loyal-customers-pay-38-more-for-staying-with-their-home-insurer/

Evidence of this type of price discrimination is not common in the UK, but in 2016 we reported on instances of drivers born overseas paying considerably more for motor insurance, which we believed to be a breach of the Equality Act 2010.[3] In an academic study, McDonald and Wren (2017) use a sample of 32,000 motor insurance prices collected online for archetypal individuals and find that the distribution of prices varies across individuals, even once the level of risk (ie the cost of provision) for each individual is controlled for.[4] Prices are found to be higher and more dispersed for older consumers and for unemployed consumers relative to those in employment.

The data used in this paper is relatively old (2006-2007) and insurance markets have evolved since, not least with greater usage of price comparison websites, so that these same results might not be found today. However, the trend of increased availability of consumer data and better analytics with which to explore it suggests that price optimisation will, if anything, have become more common in the intervening decade.

A particular concern is that even if firms do not intend to price according to these characteristics, pricing algorithms can lead to unfair biases through indirect discrimination. McDonald (2015) compares motor insurance prices before and after the implementation of the Tests-Achats ruling that banned the use of gender as a risk rating factor. The research finds evidence of indirect gender discrimination among young consumers as the impact of occupation on price changed over time.[5]

Where pricing model algorithms use machine learning on an increasing range of consumer variables there may be an increased risk that biases will emerge.[6] The FCA's findings of a variable quality of governance and controls on pricing strategies have increased our concerns with regard to price optimisation. If insurance pricing is happening in a black box then it is impossible to be sure that consumers are not being unfairly discriminated against.

Multi-brand pricing

In addition to our concerns about some forms of price discrimination, we have a concern about how pricing and marketing strategies interact in this market in a way that could potentially cause consumer harm.

Which? research[7] found that many of the quotes offered at price comparison websites are sister brands of the same insurers, but the relationship between brands is rarely transparent. Brand ownership confers information to consumers on factors such as trust and reputation, which are important to purchase decisions in insurance markets. The offered insurance contracts often

[3] Which? (2016), *Insurers in breach of equality law, says Which?*, September 2016.
[4] McDonald, S, & Wren, C (2017). Consumer search ability, price dispersion and the digital divide. *Oxford Bulletin of Economics and Statistics*, *79*(2), 234-250.
[5] S McDonald (2015) *Indirect Gender Discrimination and the TestAchats Ruling: An Examination of the UK Motor Insurance Market* (presentation to Royal Economic Society, April 2015). https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=RES2015&paper_id=791
[6] In 'Call for inputs on big data in retail general insurance', it is noted that an insurer increased the number of risk rating factors from about 15 to over 100 between the 1990s and now (FCA, FS16/5, 2015).
[7] Which? (2018), *Comparison sites: what you see isn't what you get*, September 2018.

have no quality differentiation, so that there are no clear benefits to consumers in terms of choice. Worse, the proliferation of brands can obfuscate consumer search. McDonald and Wren (2018)[8] find that UK insurers advertising for motor insurance at price comparison websites cluster the prices of their multiple brands, which allows them to crowd out other firms from a consumer's consideration set. Hence, *multi-brand pricing* with opaque ownership can lessen the effectiveness of consumer search and cause consumer harm if it leads them to make choices that they would not have done so if ownership were transparent.

Q2: Do you have any views about the fairness of outcomes from pricing practices for home and/or motor insurance? Please provide evidence to support your views.

Inertia pricing

Price discrimination can be essential to markets functioning effectively. It can encourage innovation and it can deliver direct benefits to consumers. However, discrimination on the basis a lack of consumer engagement might be believed to be unfair when the lack of engagement is the result of:

- vulnerable customers being unable to fully engage;
- companies making engagement unnecessarily difficult;
- companies exploiting consumers' behavioural biases; and/or
- consumers being unaware that company "loyalty" is not always rewarded with lower fees and charges.

We believe the first of these is particularly likely in the case of inertia pricing in general insurance markets since the older consumers who are more likely to be long-standing customers are also more likely to be more vulnerable. It is therefore likely that they will be less able to carry out effective price comparison or to haggle with their existing insurer, which can often result in a reduced price.[9]

Price optimisation

In terms of price optimisation, some optimisation practices could be considered unfair because the price-setting process is opaque and individuals charged a higher price could not know that they are subject to price discrimination. The results in McDonald and Wren (2018) are that older and unemployed consumers face higher motor insurance prices that are not explained by the level of risk of those consumers. Since these consumers are relatively low income and/or time rich then this is not an obvious case of these consumers having a higher elasticity of demand, but it is consistent with these groups having lower online search skills. The implication is that prices reflect the average ability of these consumer groups to find a good price, and markets in which search is less effective are less competitive.

We think that subjecting this example to the FCA's 6 evidential questions on fairness gives great concern about this type of price discrimination. Price optimisation by age or employment status

[8] McDonald, S., & Wren, C. (2018). Multibrand pricing as a strategy for consumer search obfuscation in online markets. *Journal of Economics & Management Strategy*, *27*(2), 171-187.
[9] See for example https://www.which.co.uk/news/2017/12/which-research-reveals-loyal-customers-being-ripped-off/.

affects a significant group of consumers, is based on intrinsic characteristics that cannot be (easily) changed, motor insurance is an essential service, and consumers in these groups are more likely on average to have characteristics of vulnerability. It seems likely that society would perceive this as socially unfair given that the price difference is not related to the level of risk.

The debate on the fairness of price optimisation in insurance markets appears to be further advanced in the United States. The National Association of Insurance Commissioners recommended that some practices of adjusting actuarially determined prices are inconsistent with insurers' statutory requirement not to be unfairly discriminatory.[10] These are adjustments on the basis of: price elasticity of demand; propensity to shop for insurance; propensity to ask questions or complain; and retention analysis (NAIC, 2015). As we outlined previously, price discrimination can deliver benefits to consumers and it is a judgement as to whether price optimisation on these, or other, factors could be considered unfair, but we would welcome the FCA ensuring that price optimisation features as part of its public debate on the fairness of pricing practices in financial services in the UK.

Q3: Do you have any views on the impact on competition of pricing practices for home and/or motor insurance? Please provide evidence to support your views.

General insurance markets in the UK seem to be competitive. Many firms offer insurance and a search for motor insurance on a price comparison website can often yield as many as 60-80 prices (McDonald and Wren, 2018). Further, underwriting profits are low or even negative (although firms do make profits from investment income and other fees and charges).

The price discrimination issues raised above are predominantly issues of protecting consumers from unfair outcomes. However, the issue of *multi-brand pricing* might impact on competition. Since consumers at price comparison websites typically reduce the number of options they wish to consider to a manageable size (a consideration set) by sorting against criteria such as lowest price, a firm clustering the prices of its brands can divert attention away from other firms. It could lead to consumers unwittingly excluding from consideration the brands of other firms and it increases the likelihood that the consumer chooses a brand owned by a multi-brand company. Overall, it could lead to consumers sampling fewer firms, reduce choice and potentially weaken competition.

Q4: Do you have any views on the appropriate way to remedy any harm or any concerns about fairness or competition that you identify under Q1, Q2 and/or Q3?

Inertia pricing

Which? supported the FCA's introduction of rules to increase transparency at renewal in 2017 as these are useful to make engagement easier for consumers. We are saddened that the FCA has found instances of potential non-compliance and hope that action will be taken swiftly to address these.

[10] NAIC (2015), *White Paper on Price Optimization*.

It seems unlikely that further demand side remedies would be sufficient to address harm where a lack of engagement is caused by consumer vulnerability. A supply side intervention seems necessary in such cases. Which? has no preconceptions about what a supply side remedy might look like, although we note that the FCA has proposed a Basic Savings Rate for the cash savings market to address a similar issue of inertia pricing. The BSR would equalise the interest rate offered to mid- and back-book customers, so that long-standing customers would not be particularly discriminated against. An analogous policy in general insurance markets would allow firms to set just two prices for all consumers of equal risk: a price for new customers and a single renewal price. The FCA could consider whether such a policy would be appropriate in general insurance markets.

An alternative would be to introduce a ceiling price for renewal prices that is some multiple of the price that would be offered to a new customer. We note that at least one firm (Barclays) already has a similar 'ceiling price' policy in the home insurance market.[11] An advantage of this is that it would give consumers an opportunity to seek redress from the Financial Ombudsman Service if firms breach the ceiling price. Currently, although consumers complain relatively frequently to the Financial Ombudsman Service about the price of insurance renewals (FOS, 2018)[12], the price is seen by the ombudsman as a commercial decision only (for examples see cases DRN935224, DRN7487092 and DRN5505560). This means it will only uphold a complaint if the insurer has been judged to have treated the customer unfairly in the process of its dealings, for example if the insurer should have recognised that the consumer was vulnerable.

Price optimisation

Which? believes that it is important that insurance companies operate with high levels of transparency. Insurance markets depend on consumers honestly and accurately providing information to insurers. If insurers were unable to trust that information then the market would break down. However, this relationship needs to be reciprocal so that consumers can trust that they are being fairly treated.

Our research on the use of consumer data found that consumers want to know "*what impact will the data use have on my life?*".[13] In the context of general insurance markets this means that, as far as is reasonable given costs and commercial sensitivity, consumers should be able to understand how their personal data is used to price their insurance contract. We have recently called on regulators and businesses to come together to understand the impacts of data usage. We think it is necessary for the FCA to examine insurance firms' pricing models, including the basis of any algorithms, to understand how these practices impact different groups of consumers, including via forms of indirect discrimination. In our work on consumer data, we called for the CMA and the Department for Business, Energy and Industrial Strategy to explore a programme of work using simulated or real individual profiles to investigate the impacts of data use on consumer markets. Such an approach could be used by the FCA in the general insurance market.

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[11] Which? Money (2018), *Loyal customers ripped off by home insurers*, September 2018.
[12] FOS, Ombudsman News, April 2018, https://www.financial-ombudsman.org.uk/publications/ombudsman-news/144/pdf/issue144.pdf.
[13] Which (2018), *Control, alt, or delete? The future of consumer data*. https://www.which.co.uk/policy/digitisation/2659/control-alt-or-delete-the-future-of-consumer-data-main-report

If pricing models are believed to be creating unfair discrimination then the FCA should consider whether new principles are needed on what factors are permissible in insurance pricing. Although, Which? welcomes the ABI and BIBA Guiding Principles for General Insurance Pricing, these focus exclusively on renewal pricing and give no wider consideration of price optimisation practices.

Of course, to make sure there isn't unfair discrimination against consumers then principles need to be supported by monitoring and enforcement. The FCA therefore needs to make sure it has the technical tools and skills to be able to monitor the market.

Multi-brand pricing

The issue of multi-brand pricing could be addressed straightforwardly by an improvement in transparency whereby insurers are required to make clear their ownership of brands. This would ensure that consumers are informed of the relationships between brands when they compare prices and will not be at risk from harm due to multi-brand pricing.

About Which?

Which? is the largest consumer organisation in the UK with more than 1.3 million members and supporters. We operate as an independent, apolitical, social enterprise working for all consumers. We are funded solely by our commercial ventures and receive no government money, public donations, or other fundraising income. Which?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives, by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.