Which? works for you

Which?, 2 Marylebone Road, London, NW1 4DF
Date: 15 November 2019
Response to: FCA General insurance pricing practices market study,
MS18/1.2 Interim Report

Summary

- Which? welcomes the FCA's Interim Report on its general insurance pricing practices market study. The report sheds light on the consumer detriment caused by a number of pricing practices in the home and motor insurance markets. We strongly support the conclusion that these markets could work better for consumers and that action is needed by the FCA to make this happen.

- We welcome that the FCA is considering a wide range of potential remedies and we recommend that it addresses the issue of inertia ("loyalty") pricing with a combination of increased transparency and restrictions on pricing practices. Firms need to be transparent about how they set prices so that consumers are able to understand the price they have been offered. However, **other remedies are also likely to be necessary, and of those under consideration by the FCA our preferred option is to prohibit firms from using a customer's likelihood of renewal or the likelihood of a consumer entering into negotiation when setting a price.**

- However, the FCA's consideration of potential remedies focuses almost solely on consumer switching and renewal pricing. There are other forms of price discrimination, affecting both new and existing customers, which also require intervention as we believe they would be judged to be of concern if they were subjected to the FCA's six evidential questions on fairness. We believe the FCA needs to go substantially further to address other unfair or harmful pricing practices including:
  - margin optimisation using excessive personal data,
  - higher prices for lower levels of coverage, and
  - lack of transparency about multi-brand price discrimination.

- Which? has concerns about the nature of the personal data used by firms to optimise prices. The FCA reports that pricing models exist which use more than 400 factors, including items on buying and media habits. Such sophisticated price discrimination has a degree of personalisation that may reduce overall consumer welfare and lead to harm for vulnerable consumers, and our research on the use of consumer data suggests that society may well view this form of price discrimination as egregious. Given these issues, **we believe the FCA should restrict the use of non-risk factors in price modelling, going further than just those factors that would address inertia pricing only.**

- We are particularly concerned about how some firms may be using the level of cover as a pricing factor. There is evidence that lower levels of cover can be more expensive (eg 3rd party or 3rd party, fire and theft compared to fully comprehensive) and in such cases consumers who purchase lower levels of cover will not receive good value. **We do not believe that selling a product in the knowledge that a superior product could be purchased for a lower price is consistent with the requirement for firms to act in the best interests of customers**, including providing value, and it therefore represents a failure to comply with the Insurance Distribution Directive.

Introduction

Which? welcomes the FCA's Interim Report into general insurance pricing practices (henceforth "the Report"). This thorough market study sheds light on the home and motor insurance markets and increases our understanding of these. We strongly agree that these markets are not working well for consumers. The Report sets out compelling evidence for the existence of harm caused by inertia ("loyalty") pricing and proposes for consideration a number of credible remedies to address this harm.

However, the Report also gives insight into other pricing practices that might cause harm to consumers and we are disappointed that the FCA has not explored these other issues further, instead choosing to limit the focus of its potential remedies almost exclusively to the issue of inertia pricing. We believe the FCA needs to go substantially beyond this to address other unfair and harmful pricing practices, including:

- margin optimisation using excessive amounts of personal data,
- higher prices for lower levels of coverage, and
- multi-brand price discrimination.

The FCA has set four goals for the UK's general insurance markets, but Which? believes that if the Market Study maintains its current narrow focus on inertia pricing then these goals cannot be achieved. Specifically, we will not have markets in which consumers can trust firms to deliver fair value and treatment for all consumers, in which firms put fair value and treatment of customers at the centre of their pricing practices, and in which firms do not engage in practices that make it difficult for consumers to make informed decisions and act to get better deals. We are therefore calling on the FCA to use this opportunity to make wide ranging improvements to consumer outcomes in these essential markets.

This response is structured as follows. In Part A, we set out our views on the efficacy of the remedies under consideration (ie Question 2) and also the remedies that you propose not to focus on (Question 3). In Part B of the response we identify other forms of price discrimination in these markets, many of which the Report has shed light on, and we set out our arguments for why these particular examples of price discrimination are likely to have a negative impact overall by dampening competition and/or causing consumer harm. It also proposes remedies that the FCA should consider to address these practices.

PART A - Inertia ("loyalty") pricing

We find the evidence presented in the Report persuasively demonstrates that long-standing customers are suffering harm in the motor and home insurance markets by overpaying for their insurance. We agree that the FCA will be required to intervene to address this issue and we welcome that it is considering a wide range of remedies. Our belief is that a combination of transparency and restrictions on pricing practices remedies will be needed to address the harm caused by inertia pricing in these markets.

Which? agrees with the FCA that it is important that insurance companies operate with high levels of transparency in the setting of renewal prices. Firms need to be transparent about how they set prices so that consumers are able to understand the price they have been offered, including why prices have changed, and this may help consumers to make informed decisions about whether to renew or to search for a different provider. The FCA's evaluation of the 2017 rules to increase transparency at renewal by showing the previous year's price shows the impact that transparency can have in improving consumer outcomes in these markets.

However, we cannot expect improved transparency alone to address the issue of unfairly high renewal prices and we are likely to find diminishing benefits from further increases in price transparency. Fletcher (2016) finds that consumer awareness, attention and an understanding of how the information can help in decision-making matters for the effectiveness of transparency (disclosure) remedies.[1] While further improvements in transparency may help some consumers to switch, others who face greater barriers will not be helped, so that a diminished pool of such consumers will be at risk of greater exploitation. It will therefore be necessary to adopt supply-side remedies.

Of the various supply-side remedies that the FCA has under consideration, our preferred option is for the FCA to restrict the use of non-risk factors used in price (margin) optimisation. To address the issue of inertia pricing this would entail prohibiting firms from using a customer's likelihood of renewal or the likelihood of a consumer entering into negotiation when setting a price. While other remedies may also be effective in addressing this issue, we favour restricting the use of non-risk factors in pricing models because it will also allow the FCA to address other harms caused by price optimisation, and we outline our arguments for this in Part B. A further advantage may be that it is a remedy for which compliance can be easily checked as firms can simply share their pricing models with the FCA.

With regard to other remedies covered in the Report:

- We are sceptical that a remedy of automatic upgrades would lead to improved consumer outcomes. We think that while it might protect customers suffering high levels of harm, we are concerned that the decision of when to implement the automatic switch will be unavoidably arbitrary. If set at a number of renewals then it could create inequity between different groups of long-standing customers. For example, automatic switching after five renewals would mean a consumer who has renewed five times is treated differently to one who has renewed four times. Further, it would diminish the incentive for consumers to search for a new price as they approach the point of being automatically switched. Alternatively, if the switch happened when a specified 'high' or 'very high' price level was reached then it would be easy for firms to game the remedy by keeping the price just below the level that would trigger the automatic switch.
- We think the FCA is right to consider which of the CMA's principles on auto-renewal are relevant for motor and home insurance markets. We support the continued use of auto-renewal and are comfortable that this might be on an opt-out basis in these markets as the harm from inadvertently not renewing a motor or home insurance policy

[1] Fletcher, Amelia (2016), *The role of demand-side remedies in driving effective competition: A review for Which?*, Centre for Competition Policy, University of East Anglia.

could be life changing. Our support for this is on the presumption that the FCA will address the harm from inertia pricing.

- We support the FCA in its decision not to consider multi-year contracts or a single switching and renewal period.

PART B - Other forms of price discrimination

The FCA is right to point out that price discrimination can lead to benefits to consumers when it intensifies competition or if it brings new consumers into the market. However, in other circumstances it may exploit consumer ignorance and reflect a lack of competitiveness in the market.

The Report sheds light on other types of price discrimination that may lead to poor or unfair consumer outcomes. These examples are not restricted to renewal pricing but instead could affect any consumer, regardless of whether they are new or long-standing. We think that subjecting these examples of price discrimination to the FCA's six evidential questions on fairness would lead to concern about these practices and in each case we think that the FCA should consider remedies to address the practice. In one case we argue it represents a failure to comply with the Insurance Distribution Directive.

1. Price (margin) optimisation models using excessive personal data

Which? is concerned about the revelations in the Report about the nature of the personal data used by firms to optimise prices (margins). The Report notes that the number of factors used by firms in their pricing models ranges from under 50 to over 400, and that these include factors *"...unrelated to risk including, for home insurance, customers' occupation, where they shop and what else they buy"* and *"Factors relating to customers' buying and media habits, including their browser type..."*. The use of these items of personal data means that these insurance prices have a high degree of personalisation. The Report does not detail how the use of this impacts on consumer outcomes, but possible implications are to reduce overall consumer welfare and lead to harm for vulnerable consumers.

Clearly, some consumers may benefit from greater competition for their business if the use of this data leads firms to identify them as having a higher price elasticity of demand and hence offer these consumers lower prices. However, economic theory suggests that this level of personalisation is unlikely to enhance consumer welfare overall in these markets. This is because the dominating effect of this price discrimination will be to appropriate consumer surplus from consumers with a high willingness-to-pay, and, crucially, since motor and (often) home insurance are essential products then this will not be countered by a market expansion effect in which those with lower willingness-to-pay are brought into the market by lower prices.[2]

There are also distributional concerns as the consumers with the most inelastic demand will suffer most as prices become increasingly personalised. This may be considered reasonable where elasticity of demand reflects willingness to pay and is determined by factors such as

[2] For a discussion of the economic impacts of personalised pricing see OECD (2018), *Personalised Pricing in the Digital Era – Note by the European Union*, DAF/COMP/WD(2018)128 or OECD (2018) *The regulation of personalised pricing in the digital era.*

income and value of time. However, a lower demand elasticity may be a consequence of low capability to search for better prices, and as the Report notes, price discrimination in these circumstances can dampen competition and will lead to worse outcomes for consumers. In an academic study of the UK motor insurance market, McDonald and Wren (2017) find that older and unemployed consumers face higher 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.[3] This accords with the Report's finding that higher prices are paid by consumers with less financial knowledge, no internet access, and who trust firms to offer competitive prices, some of which may be correlated with characteristics of vulnerability.

A further concern is that as pricing algorithms use machine learning on an increasing range of consumer variables there is an increased risk that biases will emerge that might lead to indirect discrimination on protected characteristics. McDonald (2015) compares UK motor insurance prices before and after the implementation of the Tests-Achats ruling in 2012 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.[4] Pricing models have become increasingly sophisticated in the intervening years and we note that the FCA still considers firms' oversight of pricing practices to require significant improvement. If insurance pricing happens in a black box then it is impossible to be sure that consumers are not being unfairly discriminated against by price optimisation practices.

In addition to the potential for highly personalised price optimisation models to have adverse effects on consumer outcomes, Which? research on the use of consumer data indicates that society may well view this form of price discrimination as egregious. We found that consumers tend to have fundamental and deeply held concerns about personalised pricing.[5] For many, personalised pricing undermines their sense of control and consumer choice since it is impossible to act as a savvy consumer if you have no way of knowing if you are being shown the lowest prices.

Given these issues, we believe the FCA should consider more thoroughly the fairness of firms' margin optimisation practices and it should restrict the use of non-risk factors in price modelling, going beyond just those factors that would be necessary to address inertia pricing. In some cases the use of non-risk factors is reasonable, for example factors relating to credit scores for consumers accessing premium finance, but the fairness of using other non-risk factors such as buying and media habits is doubtful. As a first step, the FCA needs to initiate a debate about which rating factors society considers acceptable for margin optimisation.

[3] McDonald, S, & Wren, C (2017). Consumer search ability, price dispersion and the digital divide. *Oxford Bulletin of Economics and Statistics*, *79*(2), 234-250.

[4] 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

[5] 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

As the FCA is aware, in the United States, the National Association of Insurance Commissioners recommends that some practices of adjusting actuarially determined prices are inconsistent with insurers' statutory requirement not to be unfairly discriminatory.[6] 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 the FCA's study on international comparison highlights, California has adopted a policy in which the use of any non-risk based factors in the pricing of general insurance is considered unfairly discriminatory and pricing models must be approved by the state's Insurance Commissioner, and this regulatory system is associated with good consumer outcomes - greater competition and lower insurance premiums for consumers.

We believe there may be further advantages from restricting the types of personal data that are not related to risk used in pricing models. Firstly, it will enable greater transparency for consumers. Our research has found that consumers want to know "*what impact will the data use have on my life?*".[7] In the context of general insurance markets this means that, as far as is reasonable given costs and commercial sensitivity, consumers should have the opportunity to understand what personal data is used and why it affects the price of the contract.

Secondly, it could increase the relative incentive of firms to invest in other innovation that may lead to longer term benefits for consumers. There has been a large increase in the number and type of factors in pricing models, and a further increase is expected in the coming years.[8] Such an arms race of investment in machine learning for price optimisation will result in extensive use of personalised pricing that is unlikely to benefit consumers, whereas this investment might be societally improving if it were instead made in other parts of the insurance value chain such as product development or claims management, for example identifying fraud.

2. Higher prices for lower levels of coverage

Which? has a particular concern about how some firms may be using the level of cover as a pricing factor. The FCA reports that the level of cover is used in modelling margin optimisation and there is academic evidence (Cannon et al., 2016) that finds lower level motor insurance cover can be more expensive (eg 3rd party or 3rd party, fire and theft compared to fully comprehensive).[9] In part this reflects some firms declining to quote for lower levels of cover, but a number of firms actually charge less for fully comprehensive insurance.[10]

Consumers may seek a lower level of cover because they are income constrained, their property is of low value or they are high risk (eg young), and higher prices for lower levels of cover may reflect that there is adverse selection in the group of customers who seek this. However, it must

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

[7] 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

[8] See, for example, Eiopa (2019), *Big data analytics in motor and health insurance: A thematic review*

[9] Cannon, E., Cipriani, G. P., & Bazar-Rosen, K. (2016). More for less? Puzzling selection effects in the insurance market. *Oxford Economic Papers*, *68*(4), 879-897.

[10] As an example of this, a search for fully comprehensive motor insurance at Compare the Market on 1 November 2019 yielded prices from 71 brands. Making no changes to this policy except to lower the level of cover to 3rd party, fire and theft resulted in a price increase for 31 of these brands.

also mean that the consumers who buy the lower level of cover are unaware that better value cover is available, and that this ignorance is exploited.

Worse still, we have found that a consumer who compares different levels of coverage can subsequently face higher prices. This is because the act of comparing prices for different levels of cover is itself used as a factor in price models. We understand that firms may argue that this is behaviour correlated with an individual's risk or the likelihood of fraud, but this search is necessary to discover that 3rd party insurance is poor value for money. In effect, consumers can be punished for searching.

We believe that the practice of charging higher prices for lower levels of cover is a failure to comply with the customer's best interests rule in the Insurance Distribution Directive. We do not believe that selling a consumer a product in the knowledge that a superior product could be purchased for a lower price is consistent with the requirement for firms to act honestly, fairly and professionally in the best interests of customers, including providing value.

3. Lack of transparency in multi-brand price discrimination

The final example of unfair price discrimination that we want to draw to the attention of the FCA is the issue of multi-brand pricing. The Report finds that some consumers are willing to pay a premium for a trusted brand, which is eminently reasonable. However, many firms operate multiple brands of which some are better known than others and it is less reasonable to use this as a pricing factor in circumstances where these brands use the same backroom operations, for example for pricing, sales and claims handling. In a choice between two brands owned by the same firm, a consumer unaware of the joint ownership might perceive the better-known brand to be more trustworthy and hence pay a premium for this, but since the dimensions underpinning trust (such as responsive to consumers, integrity, and ability to deliver the product) are all determined at a firm level then there would be no actual benefit.

Multi-brand pricing may also affect competition. Since consumers at price comparison websites typically reduce the number of options they wish to consider to a manageable size by sorting against criteria such as lowest price, then a multi-brand firm that clusters 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, reduced choice and potentially weakened competition.[11]

While the harm from multi-brand pricing is likely to be smaller than the other examples of price discrimination discussed in this response, the remedy is accordingly easier. The FCA should require firms to make clear their ownership of brands and this transparency will help consumers who would otherwise unwittingly overpay for a branded product.

[11] See 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.

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.