

Pricing differences: New vs existing customers Discussion Paper



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Invitation for comment

Background

This Discussion Paper presents the results of a monitoring study by the Emergency Services Levy Insurance Monitor (“Monitor”), which has found evidence that some insurance companies who are subject to monitoring under the *Emergency Services Levy Insurance Monitor Act 2016* (“the ESLIM Act”) are charging existing customers higher premiums than those charged for new customers in the home and contents insurance market.

The gap in pricing between new and renewing customers has been maintained over the three years of the study period and is still evident after adjusting for differences in the levels of sum-insured between new and renewing policies. The narrowing of the price gap between November 2016 and June 2017, which coincides with the period when Emergency Services Levy (“ESL”) was progressively being reduced, is of concern to the Monitor and will be subject to further investigation.

The Monitor has issued this Discussion Paper to assist in promoting informed discussion about the findings from the study and to seek feedback from interested parties, including the general public.

Call for submissions

This Discussion Paper is based on analysis undertaken by the Monitor using data that has been provided by insurers who are subject to price monitoring by the Monitor under the ESLIM Act.

Question 1: Is it appropriate to adjust for differences in sum insured in analysing the pricing gap between new and existing policies? Is the sum insured a major driver for pricing of insurance?

Question 2: What factors other than differences in the value of sum-insured might explain the pricing gap between new and existing policies? How material are these other factors to explaining the gap?

Question 3: Are there any differences in the average costs incurred by insurers in supplying new policies compared to renewing policies? If yes, what factors contribute to the difference and which factors are the most material?

Question 4: What documented pricing policies do insurers have relating to the pricing of new versus existing policies? What commercial pricing factors affect new policies versus existing policies?

Question 5: What are the pros and cons of differential pricing from the perspective of insurance companies and from the perspective of insurance consumers?

Question 6: What does the observed pricing gap between new and existing policies say about loyalty discounts that are offered by some insurance companies? Could insurance consumers be misled about the extent of the benefits they are receiving from loyalty schemes?

Question 7: Why did average base premiums for new policies, expressed as a price per \$1000 of sum insured, increase coincidentally with the phased reduction of ESL between November 2016 and June 2017?

We invite stakeholder input on the matters listed above. Submissions will be accepted until **20 December 2018**. Please send written submissions to:

Pricing Analysis Project Team
Emergency Services Levy Insurance Monitor
Email: consultation@eslinsurancemonitor.nsw.gov.au

The Monitor will consider making submissions received in response to this Discussion Paper available to the public through its website. All submissions should identify if there are any specific content which should not be made public for commercial confidentiality reasons.

Call for public comment

The Monitor also welcomes any comment from the general public, on the matters raised in this Discussion Paper. We are particularly interested in comments from members of the public:

- who have been with their home insurer for a number of years, and can provide evidence in relation to the changes in their home (building) and contents insurance premiums paid over time,
- who have switched to an equivalent policy with a different insurer after a number of years with one insurer and have evidence on any savings made in the premium paid,
- who have re-applied for insurance for an equivalent policy with the same insurer rather than accept a renewal offer from that insurer, and have evidence of any cost savings made through that process,
- on whether they consider it fair for insurers to charge existing customers a higher premium than new customers, and
- on what measures they consider regulators and/or policymakers should take to address the issue.

Written comments should clearly identify the full name and contact details of the person providing comment. Please send written comments to:

Pricing Analysis Project Team
Emergency Services Levy Insurance Monitor
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Executive Summary

The Emergency Services Levy Insurance Monitor (“Monitor”) was established by the NSW Government in June 2016 to oversee a regulatory framework for the protection of insurance consumers. This framework, which is set out in the *Emergency Services Levy Insurance Monitor Act 2016* (“ESLIM Act”), was established ahead of the NSW Government’s plans for reforming the way in which emergency services in NSW are funded. This reform was to result in the removal of the insurance-based Emergency Services Levy (“ESL”) scheme and its replacement by a property-based funding scheme known as the Fire and Emergency Services Levy (“FESL”). However, the reform has been deferred and the insurance-based funding scheme is to continue.

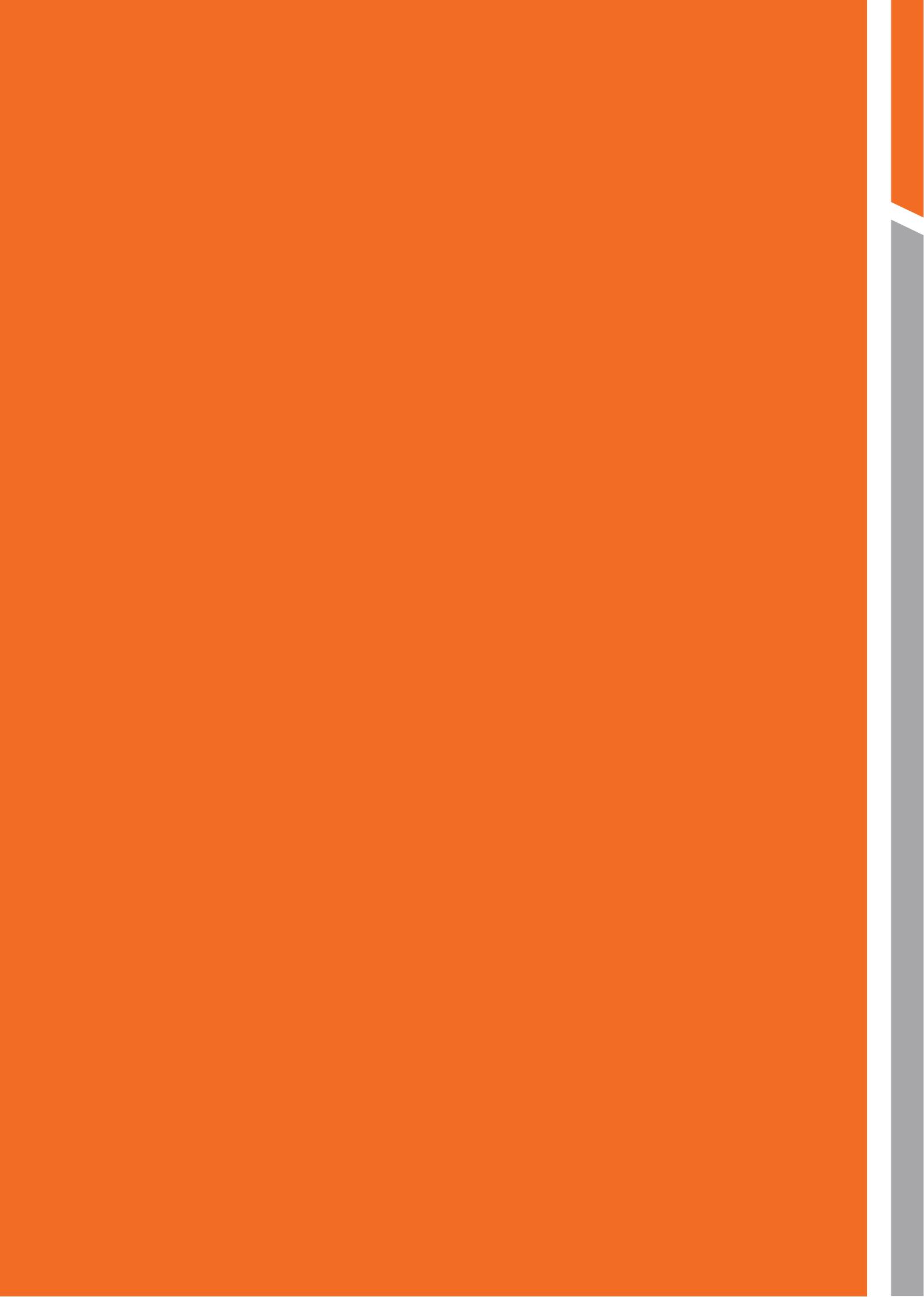
This Discussion Paper presents the results of a monitoring study by the Monitor on combined home and contents insurance, which has found evidence that some insurance companies subject to monitoring under the ESLIM Act have collectively been charging their existing customers higher premiums than those charged for new customers. Using data obtained from ten insurance companies who supply information on a regular basis pursuant to a statutory notice, the Monitor has found that:

- Average total and base premiums per policy for existing customers has consistently exceeded that for new customers between July 2015 and June 2018. Over the study period:
 - The gap in average total premium has fluctuated between \$201 and \$411 per policy. Across the three years, the average total premium per renewal policy is approximately 25% higher than that for new policies;
 - The gap in average base premium has fluctuated between \$155 and \$281 per policy. Across the three years, the average base premium per renewal policy is approximately 25% higher than that for new policies;
- During the month of June 2018, average total premiums for policyholders who renewed was \$1,678 per policy compared with \$1,323 per policy for new customers, equating to a price gap of almost 27%. The gap does not appear to be fully explained by introductory or online discounts for new customers, and would be even larger if the impact of loyalty discounts offered by some insurers was to be removed.
- The data for a number of insurers in the study point to a clear practice of escalating the sum-insured on renewing policies each year. Increasing the sum insured each year can be important as a way to avoid under-insurance, but over-insurance can also be a problem for consumers.
- Differences in the sum insured value can result in premiums for new and existing policies diverging. The Monitor has adjusted for differences in sum insured in making the pricing comparisons in this study but remains open about the merits of doing so. The analysis indicates that only some of the pricing gap may be explained by differences in the levels of sum insured for new and renewing policies.
- There is evidence that the insurers in the study increased their pricing of base premiums (adjusted for the sum insured asset value) for new building and contents policies coincidentally with the reduction in ESL rates that occurred between November 2016 and June 2017. This finding is of concern to the Monitor and will be subject to further investigation.

The Monitor acknowledges that the findings from this study reflect the average results across all ten insurance companies, and it is possible that the pricing gap identified may be attributable to some insurers and not others.

The results from this monitoring study raises a number of questions as outlined in the section on “Invitation for comment”.

The Monitor invites input and comments from interested parties on these and any other matters highlighted in this Discussion Paper. The Monitor will have regard to any further information that insurers, policyholders and others may choose to provide in their submissions in response to this Discussion Paper in conducting further investigation on this matter.



1. Introduction

1.1 Background

1.1.1 The Insurance Monitor

The Monitor was established by the NSW Government in June 2016 to oversee a regulatory framework for the protection of insurance consumers. This framework was established ahead of the NSW Government's plans for reforming the way in which emergency services in NSW are funded. This reform was to result in the removal of the insurance-based Emergency Services Levy ("ESL") scheme and its replacement by a property-based funding scheme known as the Fire and Emergency Services Levy ("FESL").

On 30 May 2017, the NSW Government announced that the planned reform would be deferred. Legislation was subsequently passed to, amongst other things:

- continue the insurance-based funding scheme through the establishment of an emergency services contribution scheme under the Emergency Services Levy Act ("ESL Act") which would be administered by Revenue NSW, and
- amend the ESLIM Act to extend the term office of the Insurance Monitor to 30 June 2020, and to facilitate ongoing monitoring of insurance companies during an extended transition period to the FESL.

As a result of the above, insurance companies continue to be required to make contributions to fund the activities of fire and emergency services in NSW. For the 2018/19 financial year, insurers are expected to contribute \$780 million in funding. It is expected that most insurers will recover this cost by charging an ESL on relevant insurance policies.

The general functions of the Monitor are set out in Section 9 of the Act. They are:

- (a) To provide information, advice and guidance in relation to the emergency services levy reform and prohibited conduct,
- (b) To monitor prohibited conduct and compliance with the Act and the regulations,
- (c) To monitor prices for the issue or regulated contracts of insurance,
- (d) To monitor the impact of the emergency services levy reform on the insurance industry and levels of insurance coverage,
- (e) To prepare and publish guidelines relating to the operation and enforcement of the Act and the regulations,
- (f) To receive complaints about prohibited conduct and to deal with them in accordance with the Act,
- (g) To investigate and institute proceedings in respect of prohibited conduct or any other contravention of the Act or the regulations.

The ESLIM Act provides the Monitor with information gathering powers to carry out those functions related to price monitoring.¹

In addition to the functions set out in Section 9, Part 3A of the ESLIM Act requires the Monitor to investigate and assess whether insurance companies are liable for over-collection of ESL.

¹ ESLIM Act, Section 10(2), 10(3) and 10(4).

1.1.2 Purpose of this Discussion Paper

This Discussion Paper presents the results of a monitoring study by the Monitor on home and contents insurance, which has found evidence that major insurance companies subject to monitoring under the ESLIM Act are charging their existing customers higher premiums than those charged for new customers.

The monitoring study utilises data obtained from major insurance companies who supply the information on a regular basis pursuant to a statutory notice. Whilst the evidence suggests that there is a price difference between new and existing customers, the full reasons for this and the implications it gives rise to are yet to be determined fully by the Monitor.

The Monitor has issued this Discussion Paper to promote informed discussion about the findings from the study and to seek feedback from interested parties.

1.2 Why is this subject of interest to the Monitor?

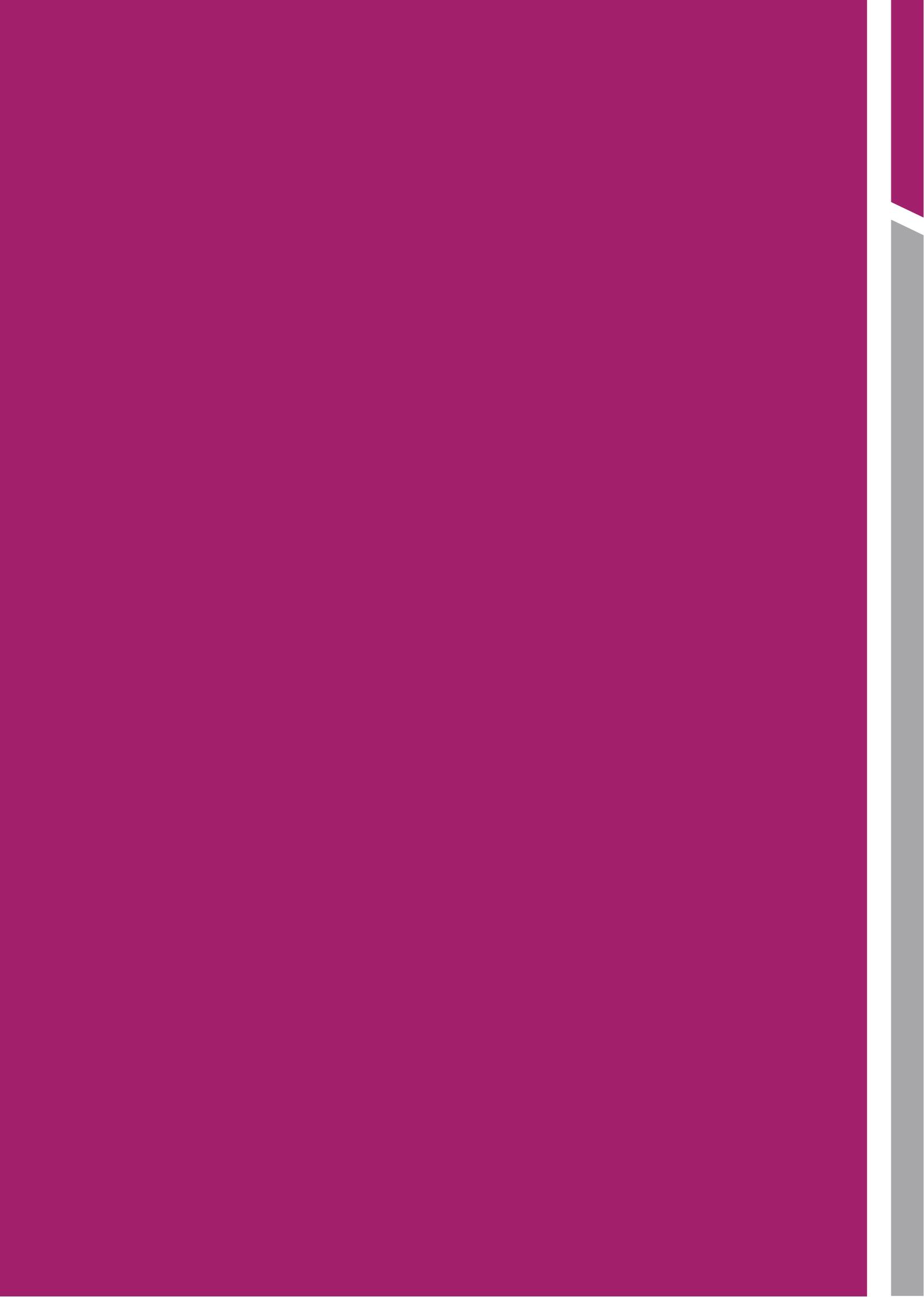
One of the functions of the Monitor under the ESLIM Act is to monitor prohibited conduct and compliance with the Act. There are two types of prohibited conduct in the ESLIM Act. The first is a prohibition against price exploitation (Section 14) and the second is the prohibition against false or misleading conduct (Section 15).

The prohibition in relation to price exploitation applies at the level of an individual insurance policy as well as in the aggregate. The ESL is one of a number of components that forms the 'price' of an insurance contract that is subject to monitoring under the ESLIM Act. Although there is no legislation prescribing how insurers should recover the cost of their assessed contributions from individual policyholders, the way in which insurers exercise their discretion to set base premiums and ESL rates remains relevant to the Monitor.

Price differences to different customers may reflect cost differences relating to the supply of new and renewed policies. However, price differences may also be consistent with price discrimination if price differences do not reflect cost differences. This could also mean some customers may be cross-subsidising other customers. Given the existing practice of insurers charging ESL on a percentage basis on base premiums, the impact of any cross-subsidisation will be magnified on the final premiums.

To the extent that differential pricing is being used by insurance companies, some customers will face base premiums that may be inflated above cost to reflect differential pricing factors possibly consistent with their willingness to pay. This means that the ESL added onto the policy will also be similarly inflated.

This issue is discussed further at Section 2.4.



2. Differential pricing

2.1 What is differential pricing?

Differential pricing (also known as dual pricing, flexible pricing or discriminatory pricing), is the practice of selling the same product or service to different customer groups or customer segments, at different prices, even though the cost of supplying the product is the same. It is a form of price discrimination that takes into account customer-specific factors that are unrelated to cost.

Prices can be set to vary by a range of dimensions including time (of day, week, year or season), product brand, frequency of purchase, or length of contract to supply, or customer-specific attributes such as age, gender or capacity to pay, to name a few. Common examples include the pricing of airline tickets (which can vary by time of travel or time of year) and loyalty cards which provide discounts to entice customers to return or buy more.

Differential pricing is made possible where the supplier is able to segment customers by their particular characteristics to charge different prices and ensure that the customer segments remain separated. Economic theory identifies the following three types of price discrimination:

- 1. First degree (or pure price discrimination)- the seller is able to exploit the willingness of consumers to pay by charging a different price to each consumer of the same product based on their willingness to pay**
- 2. Second degree - the price of the product or service varies according to the quantity demanded (e.g. bulk purchases) or where the buyer seeks special qualities**
- 3. Third degree - the price of the product or service varies by attributes such as location, age, sex, and economic status (or proxies for economic status, e.g. students, pensioners, children).**

Differential pricing need not reflect the use of cross-subsidies by a firm. Cross-subsidy is not just where one group of customers pays more than another. Where a cross-subsidy is present, it means that some products or services (and the customers who buy them), are served below (incremental) cost, and are being subsidised by another product or service that is charged higher prices. The firm therefore intentionally makes losses in one market which are funded by excess returns in another related market. Cross-subsidies tend to be of interest to competition regulators (e.g. the ACCC) because such practices can make it more difficult for other firms to compete in the subsidised market.

2.2 Is differential pricing harmful?

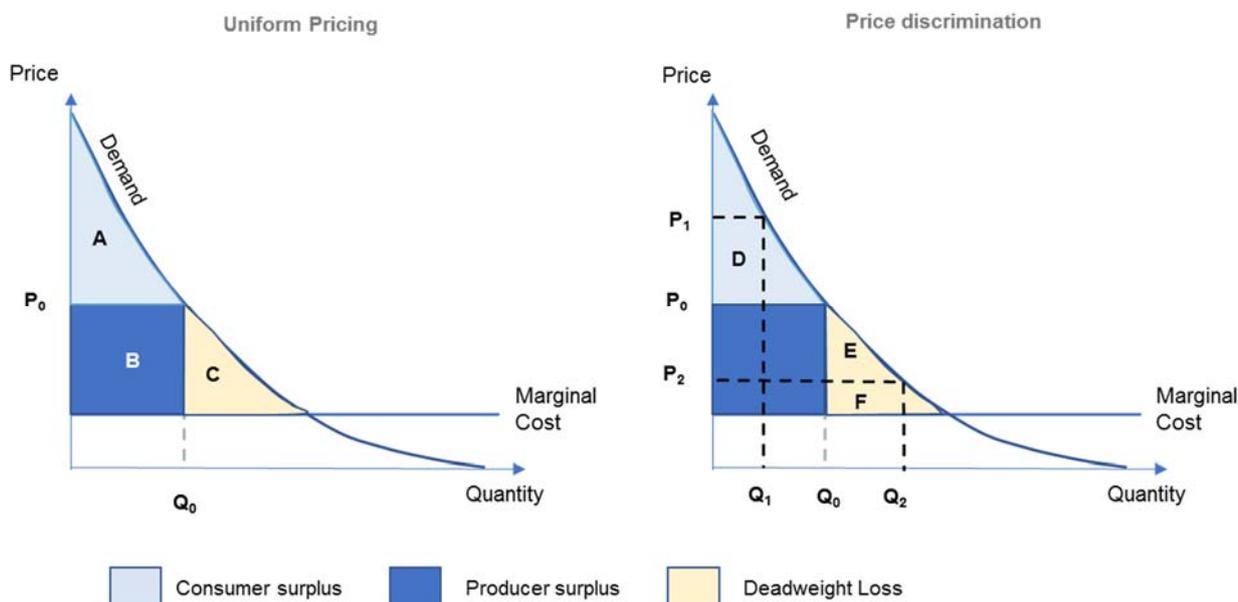
Differential pricing enables firms to discriminate between different customers by charging them a price that is based on non-cost related factors. It is clear that differential pricing is common in many markets and in many cases, the practice is widely accepted by consumers and does not raise concerns with regulators or policymakers. For example, few people would complain that children and pensioners may be given special meal prices at restaurants, or that retail incentives such as 'two for the price of one' discounts are inappropriate.

The effect of differential pricing on consumers total welfare depends on the characteristics of the relevant market. In technical economic terms, price discrimination can affect the way the market shares the consumer surplus, producer surplus and deadweight loss that arises from the outputs of the market. As shown in Figure 1 below, depending on how these shares shift when some prices move up from P_0 to P_1 (and output reduces from Q_0 to Q_1), and others move down from P_0 to P_2 (and output expands from Q_0 to Q_2), there may be an overall increase or decrease in the consumer surplus and the producer surplus, which makes up total welfare.

For example, when the price charged to some customers reduces from P_0 to P_2 there is a welfare gain that is made up of a producer surplus (region F) and a consumer surplus (region E). Customers in this part of the

market (who have lower levels of willingness to pay) were previously not served. Overall consumer welfare is increased if region E is larger than region D (which becomes a producer surplus when prices are increased from P_0 to P_1), but even then, some customers (those with higher willingness to pay) are paying a higher price than under uniform pricing. This redistribution of welfare raises questions relating to ‘fairness’.

Figure 1: Illustration of the welfare effects of price discrimination



Consumer surplus is represented by the Region A. It is the total sum across consumers of the difference between each consumer's maximum willingness to pay and the price actually paid. Essentially, it is the amount of 'enjoyment' consumers get, net of the price they have paid.

Producer surplus is represented by the Region B. It is the total of the suppliers' profits above cost and a reasonable return on capital invested. It represents the difference between price and cost across all sales made at the chosen price.

Deadweight loss represents the value of the consumer surplus lost when a potentially beneficial trade does not take place. This happens when firms set a price that is not at the most efficient level, and as result output is reduced, and hence some transactions are not taking place. This is Region C.

Price discrimination may arise as a result of competitive pressures, but depending on market circumstances, it may have adverse effects on competition. As the Financial Conduct Authority (“FCA”) in the UK has noted, it is often difficult to assess the reasons for price differences in markets:

For example, in the market for general insurance it is often difficult to disentangle cost-based causes of price differences from price discrimination. To illustrate, suppose insurance premiums vary between two postcodes. How can we be sure whether that is because of differences in the actuarial risk between the postcodes (cost-based pricing) or because people have different levels of willingness to pay in the two postcodes (price discrimination)?²

Advances that are being made in the area of ‘big data’ are increasingly allowing firms, including general insurers, to create more individualised products and to price according to individual customer characteristics reflecting willingness to pay. Whilst this may be a positive in terms of innovation, there can be trade-offs with respect to privacy considerations, appropriate use of personal data, and competition and pricing fairness.³ Where individualisation and pricing based on specific customer attributes becomes more pervasive and intersect with attributes that are common to vulnerable consumers or consumers which are unable to participate fully in the competitive market, such pricing practices may deserve greater scrutiny. The UK Government and the Competition Markets Authority (“CMA”) for example, have recently announced the commissioning of new research that will examine “the practice of retailers targeting online shoppers and

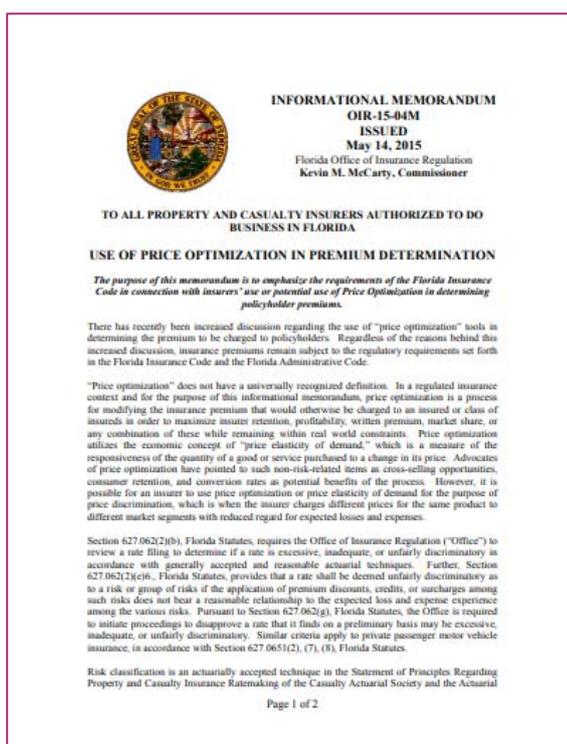
² Financial Conduct Authority, Price discrimination in financial services, How should we deal with questions of fairness, Mary Starks, Graeme Reynolds, Chris Gee, Gaber Burnik & Lachlan Vass, Research Note, July 2018, page 3.

³ Refer ESLIM Occasional Paper, Monitoring of Insurance Premiums in a world of Big Data, June 2018.

charging people different prices for the same items through personalised pricing, such as holidays, cars and household goods.”⁴

The issues may also be more acute for insurance products that already discriminate by charging different prices based on the risk classification of an insured. There may also be concerns about the potential reduction in the comparability of increasingly personalised products, which would make it harder for consumers to assess different offers and thus reduce the effectiveness of competition.

In the USA, the use of price discrimination (or price optimisation as it is commonly referred to there) for insurance is unlawful. Regulators in 18 states (California, Connecticut, Colorado, Delaware, Florida, Indiana, Maine, Maryland, Minnesota, Missouri, Montana, Ohio, Pennsylvania, Rhode Island, Vermont, Virginia, Washington and New York) and the District of Columbia have issued bulletins prohibiting or restricting the use of price optimization in personal lines ratemaking.



In Florida, for example, a memorandum was issued by the Florida Insurance Commission in May 2015 confirming the prohibition. Then Commissioner Kevin McCarty cited Florida insurance statutes that say the Office of Insurance Regulation was required to review a rate filing to determine if a rate is excessive, inadequate, or unfairly discriminatory in accordance with “generally accepted and reasonable actuarial techniques.” It was noted that the law provided that a rate shall be deemed unfairly discriminatory as to a risk or group of risks if the application of premium discounts, credits, or surcharges among such risks does not bear a reasonable relationship to the expected loss and expense experience among the various risks.

The move was applauded by the Consumer Federation of America (“CFA”) which months earlier had alleged it had found evidence of the use of price optimisation by insurance company Allstate Property & Casualty Company (“Allstate”) in relation to motor insurance premiums.⁵ It was alleged that Allstate was charging higher premiums for individuals who were unlikely to shop around to find a better price.

The CFA wrote to a number of State Insurance Commissions citing the use of “marketplace considerations” as a risk factor by Allstate, which had no bearing on expected losses of the insured.⁶

2.3 Charging loyal customers more

The issue of a “loyalty tax” has recently received widespread attention in home insurance markets in the UK. The Insurance Monitor is aware that the FCA has found evidence that premiums for home insurance increases the longer a customer remains with an insurer. Figure 2 below shows this effect based on policies which renew each year, from three insurance providers. For example, customers who have renewed their insurance over five years pay on average 70% more than new customers.

⁴ <https://www.gov.uk/government/news/government-and-cma-to-research-targeting-of-consumers-through-personalised-pricing>

⁵ https://consumerfed.org/press_release/consumer-groups-applaud-florida-insurance-commissioner-mccarty-for-directing-insurers-to-stop-price-gouging-consumers/

⁶ <https://consumerfed.org/pdfs/CFA-letter-NAIC-commissioners-12-16-2014.pdf>

Figure 2: Price increase per number of renewals



Source: FCA, Price discrimination and cross subsidy in financial services, Occasional paper 22, September 2016, page 6.

The UK Financial Ombudsman has also highlighted similar cases:

*“New insurance products are usually offered at a discount, to attract new customers. Often this price is set at a level below the actual cost of the policy, with the insurer aiming to retain the customer and recover its initial discounts through subsequent renewal increases. Typically, this is done over a number of years, but in some cases, we see insurers continue to increase the premium even after the policy has become economic to provide. After a number of years, it should normally be quite apparent to an insurer when a loyal customer isn’t engaging with them at renewal... This can lead to situations where insurers know some of their customers are paying more than they could have done for their insurance each year. At the same time, customers with similar risk profiles, often on newer products – but sometimes even the same product – pay significantly less.”*⁷

Very recently, the Citizens Advice Bureau in the UK lodged a ‘super-complaint’ with the Competition Markets Authority (“CMA”) on excessive pricing for disengaged customers and urged the CMA to take action.⁸

Excessive prices for disengaged consumers

A super-complaint to the Competition and Markets Authority



“As a consequence of its response to this complaint, the CMA should undertake a thorough, cross-sectoral market study into the penalty paid by loyal and disengaged consumers. While we have identified its existence in five markets, this study should consider the loyalty penalty wherever it occurs and propose recommendations and remedies that can be implemented by itself, sector regulators and the Government.”

⁷ Ombudsman News Issue 144, <http://www.financial-ombudsman.org.uk/publications/ombudsman-news/144/144.html>

⁸ A super-complaint is a complaint made in the UK by a state-approved agency or organisation on behalf of consumers which is fast-tracked to a higher authority. Prior to 1 April 2014, this was the Office of Fair Trading, but following its dissolution, the official body is now the CMA. The CMA is required to publicly respond to a super-complaint within 90 days outlining if they believe in the issue, and if not, why not, and how they intend to deal with it. Refer [https://www.citizensadvice.org.uk/Global/CitizensAdvice/Consumer%20publications/Super-complaint%20-%20Excessive%20prices%20for%20disengaged%20consumers%20\(1\).pdf](https://www.citizensadvice.org.uk/Global/CitizensAdvice/Consumer%20publications/Super-complaint%20-%20Excessive%20prices%20for%20disengaged%20consumers%20(1).pdf)

The practice of charging higher prices for customers who have a preference for renewing their insurance policies in particular, raises some difficult questions. A customer may prefer to renew because s/he is informed and deliberately chooses to do so. On the other hand, it may be that the customer is uninformed and/or automatically renews because s/he is disengaged with the insurance purchasing decision or suffer from other behavioural biases. Consumers who fall into the latter category are unlikely to consider their treatment as being fair:

“...in the market for general insurance many firms increase prices on renewal in an attempt to charge higher prices to more inert customers. Views are divided on whether price discrimination in these circumstances is fair. Some may consider that more active consumers are being rewarded for shopping around and finding a good deal. Others may consider that more active consumers are getting a reward at someone else’s expense and that firms are penalising loyal customers or those who are less able to find a better alternative.”⁹

Earlier work by the FCA led to disclosure-related changes in renewal notices designed to ensure that customers were prompted or reminded of the need to ‘shop around’. However, the FCA at that time did not conclude whether or not such differentiated pricing in home insurance was a cause for concern. It warned that problems:

“... may arise when a group of consumers is targeted with below-cost prices. Below-cost pricing can be inefficient, where it encourages excessive use of a service by consumers, and can be detrimental to competition, where it deters entry or is used to drive rivals from the market. In the same way, price discrimination can exclude rivals.”¹⁰

More recently, however, the FCA has confirmed it has concerns about price differentiation relating to new versus existing customers in the home insurance market.¹¹ Its recent thematic review on pricing practices in the home insurance market found that:

1. Firms were failing to have appropriate and effective strategies, governance, control and oversight of their pricing practices and activities, such that they were unable to reliably assess and evidence where they are treating their customers fairly
2. Differential pricing is leading to some identifiable groups of consumers paying significantly higher prices than other identifiable groups of consumers with similar risk and cost of serve characteristics.
3. There was risk of discriminating against consumers through using rating factors in pricing based (directly or indirectly) on data (including third party data) relating to or derived from protected characteristics.

Significantly, the FCA found that:¹²



The greatest potential for harm we identified arose from the price differentiation relating to long term renewal consumers. This is particularly in those firms with larger books of older renewal business (including back book and legacy products). Our work showed that cohorts of consumers who have renewed their home insurance with their insurer for many years are on average paying prices significantly above the cost of provision.



⁹ Ibid, page 3.

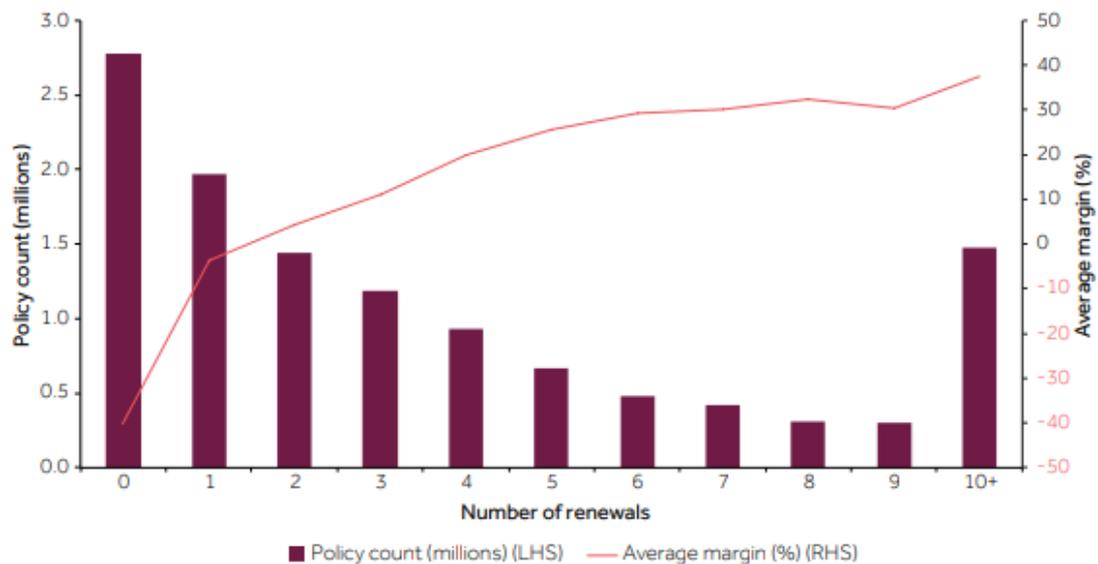
¹⁰ Financial Conduct Authority, Occasional Paper No 22, Price discrimination and cross subsidy in financial services, Occasional paper 22, September 2016

¹¹ Financial Conduct Authority, Pricing Practices in the retail general insurance sector: Household Insurance, Thematic Review, TR18/4, October 2018.

¹² FCA, ibid, page 13.

The chart below illustrates the extent of the margin differences that the FCA estimates arises from the price differentiation between new and existing customers.

Figure 3: Extract from FCA TR18/4: Policy count and average margins by number of renewals



The FCA has noted that price discrimination of this nature creates winners and losers:

- Potential winners were to be found mainly in the front book/newer cohorts of business. They included groups such as private renters with children, those with low credit scores, unemployed renters and those with contents only insurance.
- Potential losers were to be found mainly in the renewal book. They included groups such as those who are over 65 years old, those who pay monthly, those who auto-renew, those who have made previous claims, and those who have building only insurance.

2.4 Why is this relevant to the Monitor?

The Monitor has a number of functions in the ESLIM Act, including ensuring that insurers do not breach the prohibitions in relation to price exploitation and false or misleading conduct in relation to the ESL reform.

Price exploitation is defined in Section 14 of the ESLIM Act which is reproduced below.

14 Price exploitation

- (1) For the purposes of this Act, an insurance company engages in price exploitation if:
- (a) the insurance company issues a regulated contract of insurance and
 - (b) the price for the issue of the regulated contract of insurance is unreasonably high having regard to:
 - i) the ESL reform, and
 - ii) the emergency services contributions required to be paid by the insurance company, and
 - iii) the historical ESL rates charged by the insurance company, and
 - iv) the costs of supplying insurance against loss of or damage to property, and
 - v) any other matters prescribed by the regulations.

An insurance company who is found to have contravened the prohibited conduct provisions of the ESLIM Act could face penalties of up to \$10 million.

The Guidelines on the prohibition against price exploitation outline a number of points in relation to the provision, two of which are particularly relevant to this Discussion Paper.

Firstly, the prohibition applies at the level of the price of an individual contract of insurance that is a relevant policy within the scheduled classes of insurance issued by an insurance company and regulated under the ESLIM Act (Guideline 1). This means that when determining whether prices have been unreasonably high, it is sufficient if that determination is made in relation to a single contract of insurance. Nevertheless, the insurance company's overall pricing will be relevant in considering the matters listed in section 14(1)(b).

Secondly, the prohibition relates to the total price charged for a regulated contract of insurance and the major components of price, including the base premium, ESL, goods and services tax (GST) and duty, and brokerage or commission (Guideline 2). The elements of 'price' include a number of discretionary components which will require individual consideration in establishing if a price is unreasonably high. The ESL is levied on base premiums and accordingly, the level of base premiums charged in each case will affect the dollar amount of ESL that is added to the premium.

The phrase 'unreasonably high' is not defined in the ESLIM Act and the guidelines state that the Monitor will have regard to the ordinary meaning of the words used, their statutory context and the criteria in the Act. The question of whether a price is unreasonably high will require consideration of the reasonableness of the costs of supplying insurance against loss of or damage to property, which may be reflected in the base premium.

The Guidelines note that examining the costs of supplying insurance will inevitably entail some consideration of the level of insurer profitability. This may involve considerations of the appropriateness of cost levels, cost allocation or cross-subsidy associated with insurance premiums subject to ESL contributions.¹³

To the extent that differential pricing is used by insurance companies who are subject to the ESLIM Act, the Monitor may have concerns that some customers are being charged prices that are unreasonably high and may be bearing an unreasonably high share of the insurer's assessed contribution. This is because where the base premium is inflated above cost to reflect differential pricing factors, the dollar value of the ESL added onto the policy, which is generally charged on a percentage basis, will also be similarly inflated, even if the rate of ESL charged is applied uniformly across all policyholders within a class of insurance.

The Monitor is aware that there is no legislative provision prescribing how insurers should recover the cost of their assessed contributions from individual policyholders. This, however, does not imply that insurers should have unfettered discretion in the way ESL is charged to policyholders. The Guidelines state that the Monitor "*may have concerns if a policyholder was charged a disproportionately higher amount than another policyholder in equivalent circumstances.*"¹⁴

It is worthwhile noting that in a previous (April 2017) version of the Guidelines that was in effect prior to the deferral of the ESL reform, the Monitor did refer to the importance of pricing new policies on the same basis as existing policies.¹⁵

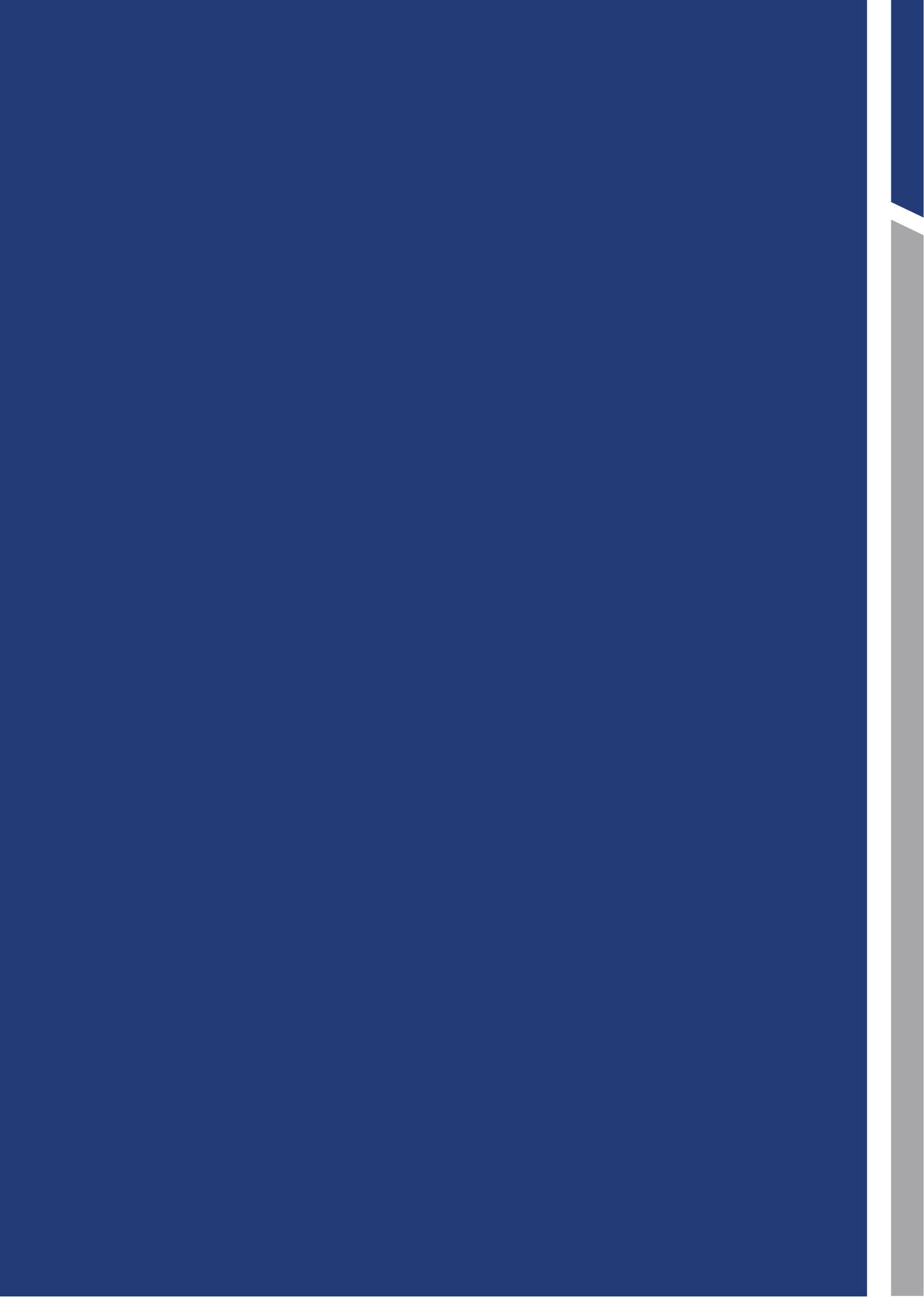
The Monitor notes that whilst the prohibition against price exploitation applies to an individual contract of insurance, its price monitoring of insurers has to date focussed on aggregate monthly premiums and ESL. This approach was taken having regard to the costs and benefits of a light- versus a more heavy-handed approach to monitoring, given the effectiveness of competition in the industry and the conduct of insurers more broadly.

¹³ Paragraph 82-83, Guidelines on the prohibition against price exploitation, December 2017

¹⁴ Guidelines on the prohibition against price exploitation, December 2017, page 16.

¹⁵ Guidelines 11 of the April 2017 version of the Guidelines on the prohibition against price exploitation stated: "Insurance companies will minimise the risk of contravention of the prohibited conduct prohibitions of the Act if premiums for new policies, issued in 2017-18, are determined using the same methodology as premiums for existing policies being renewed in 2017-18."

However, where insurer pricing practices vary between different subsets of the customer base (including possibly via branding), there is a genuine risk that movements in the base premium which offset or add to the price paid on an insurance policy as the ESL changes during transition period, are overlooked. Monitoring overall average pricing of policies of individual insurers may not be effective in these circumstances. The Monitor is concerned to ensure that it maintains an effective program of ongoing monitoring of insurers over time.



3. The monitoring data

3.1 Data

The ESLIM Act provides the Monitor with information gathering powers to assist the Monitor in carrying out his functions under the Act. These powers are set out in Part 5, Divisions 1 through 4 of the ESLIM Act. Section 57 of the ESLIM Act in particular, sets out the circumstances under which an inspector appointed by the Monitor, may require a person to provide information in connection with any matter arising under or in connection with the functions of the Monitor in the Act.

57 Requirement to provide information and records

- (1) An inspector may, by notice in writing given to a person, require the person to furnish to the inspector such information or records (or both) as the inspector requires by the notice in connection with any matter arising under or in connection with the functions of the Monitor under this Act.

3.1.1 Collection method and source

The underlying data analysed by the Insurance Monitor is based on information supplied by insurance companies. This information was requested pursuant to a statutory notice issued under Section 57 of the ESLIM Act,¹⁶ and forms a central component of the dataset used to monitor prices and prohibited conduct. The dataset is also used to inform the Monitor's assessment of over-collection of ESL by individual insurance companies.

As Figure 4 below indicates, each insurer is required to supply information relating to monthly aggregate actual information on premiums received or earned, policies / risks issued and in force, and the ESL associated with the premiums. In each of these categories, insurance companies are required to breakdown the data for new policies versus renewing policies. This information is provided for the 6 classes of insurance which are subject to the emergency services contribution scheme which are:¹⁷

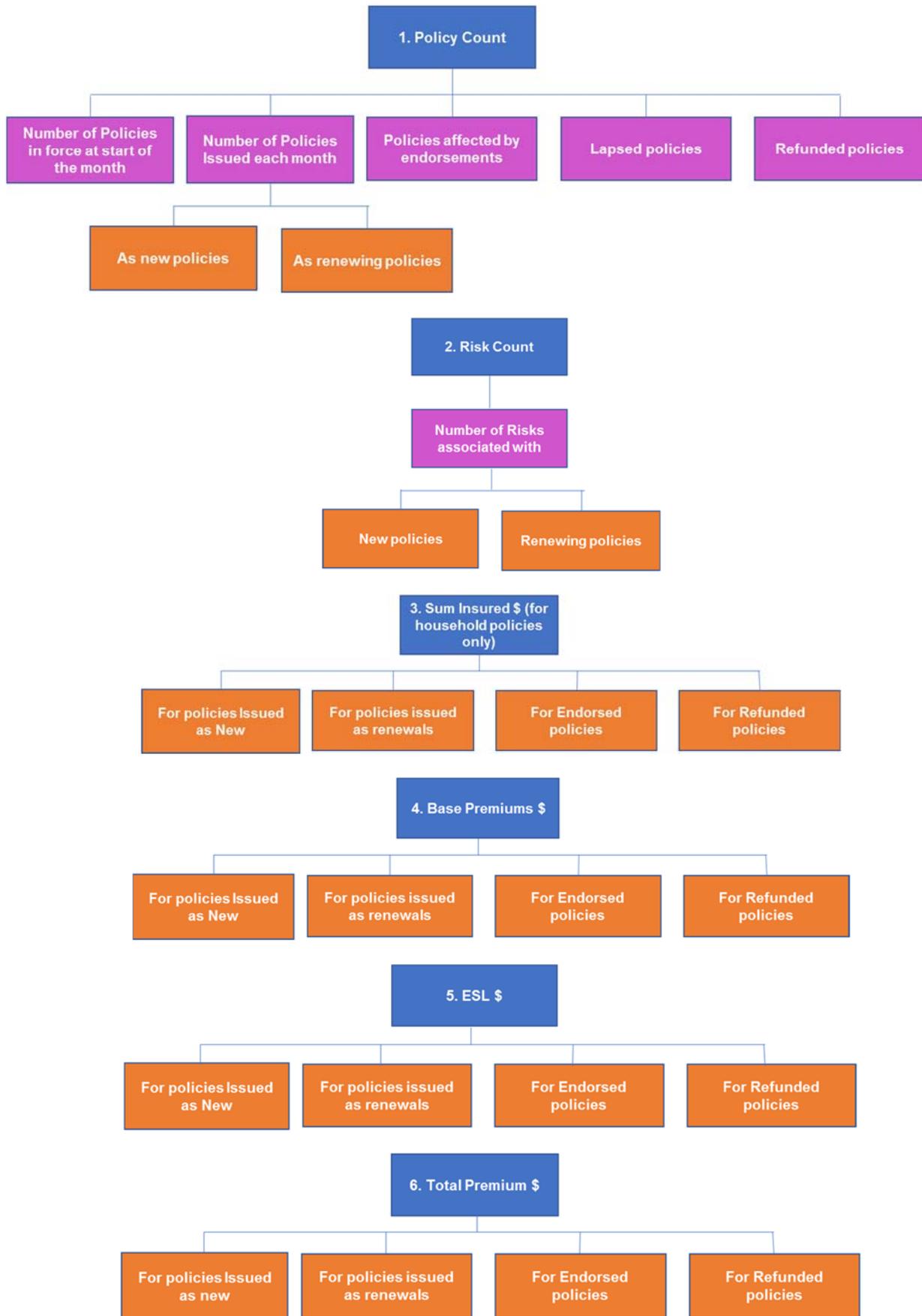
- Commercial property
- Home – building only, contents only and combined building and contents
- Personal combined on personal jewellery and clothing, personal effects and works of art
- Motor vehicle / motor cycle
- Marine and baggage
- Crop and livestock

In the home insurance class, the Monitor's data request requires insurers to separate the data for building only, contents only and combined building and contents policies.

¹⁶ <https://www.eslinsurancemonitor.nsw.gov.au/section-57>. Refer website content under heading "Monthly Aggregate Data Request".

¹⁷ <https://www.eslinsurancemonitor.nsw.gov.au/section-57>. Data is provided in the form specified in Schedule B1.

Figure 4: Underlying data



3.1.2 Insurers supplying information

The data used for this monitoring study has been provided by 96 of 161 insurance companies who lodged a Return of Premium with the NSW Department of Justice for the 2016 financial year. These companies do not include entities who are owners of property located in NSW but insured with a foreign insurer, companies who reported aggregate premiums under \$100,000, companies that were duplicates (e.g. had Lloyds as well as non-Lloyds operations) and companies that reported nil premiums.

Some of the companies that supply the information used in this study also supply premium quotations to the Monitor on a monthly basis under a separate statutory notice.¹⁸ These quotations are provided on a 'standardised' basis, for specified locations, coverage and policyholder attributes.

Since July 2018, the companies supplying the standard quotes have also been providing quotes on the basis of a new customer and for a customer renewing for the first and fourth consecutive time. The Monitor analyses this data separately and is able to compare the information from both data sets to gain further insights about insurer pricing practices.

The Monitor has identified a number of issues and data inconsistencies with the monthly quotes and is in the process of the following up with individual insurers who supplied these quotes. The data for the monitoring study in this Discussion Paper does not utilise any of the data from the monthly quotes.

3.1.3 Frequency of collection

Insurance companies providing data to the Monitor are classified into two categories – 'Tier 1' and 'Other'.

Tier 1 companies are the largest 10 insurance companies in each of the classes of insurance making up the 2015/16 Return of Premium form. These companies were initially required to provide historical aggregate data for each month between July 2015 and June 2017. Following this, the companies have been providing updated data on a three-monthly cycle. Each update also allows for companies to revise the data provided for the last month of the previous set of data. This has been necessary as there are often delays with premiums flowing through from intermediaries to underwriters in relation to policies that are intermediated.

Companies in the 'other' category are those that are not 'Tier 1' companies. These remaining companies were requested to provide historical aggregate data for each month from July 2015 to June 2017. No further information will be sought from these companies until December 2019, when the data for July 2017 to June 2019 will be requested in one tranche.

3.2 The companies in our study

The data for this study is based on combined building and contents home insurance policies issued by Tier 1 insurance companies in the home insurance segment. These insurers are listed in Table 1 below, along with some of the brands they are associated with.

Table 1: Insurance companies studied

Insurance company	Major home and contents brands underwritten
Insurance Australia Limited	NRMA, CGU, WFI, Coles, Sharecover, Poncho, SGIO, IAL, RACV
AAI Limited	Suncorp, GIO, AAMI, APIA, Resilium, Vero, Terri Scheer Insurance, Shannons, Bingle
Allianz Australia Limited ¹⁹	Allianz, NAB, Catholic Church Insurance, Citigroup, HSBC Bank, CUA
QBE Insurance	QBE, Elders, OnePath/ANZ

¹⁸ Refer https://www.eslinsurancemonitor.nsw.gov.au/sites/default/files/s57Letter_May_2018.pdf

¹⁹ Allianz operates through a very large number of brands. Only a few are listed in this table

Insurance company	Major home and contents brands underwritten
Commonwealth Insurance	Commlnsure
Westpac General Insurance	WGI
Youi	Youi
Auto & General	Budget Direct, 1300 Insurance, Aussie, Australia Post, Dodo Insurance, ING, Virgin Money, Macquarie, Maxxia Insurance
Hollard	Woolworths Insurance, Kogan, Real Insurance, Australian Seniors Insurance Agency, Max Insurance, L.J. Hooker, SGUA,
Chubb Insurance	Chubb Insurance

The top 4 insurers together account for over 77% of the NSW market based on premiums declared in Return of Premiums submitted for the 2016/17 financial year.²⁰ The remaining 6 companies account for almost 20% of that market.

3.3 Metrics analysed

The data obtained from Tier 1 insurers allows the calculation of a number of metrics. These include:

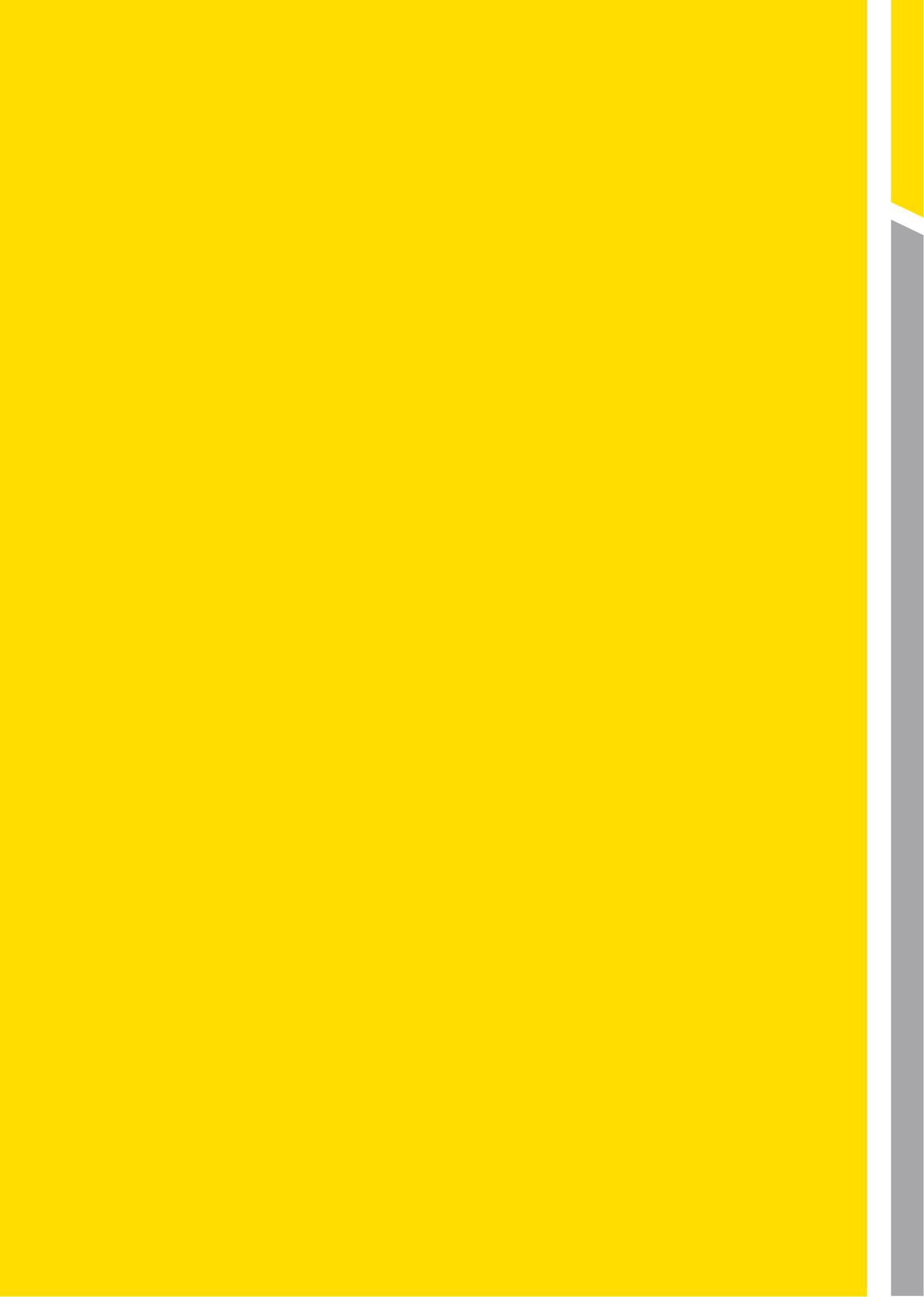
- Average base and total premiums per policy
- Average ESL per policy
- Average base and total premium adjusted for sum insured

'Average' calculations reflect the monthly average calculation of the relevant metric. Average monthly premiums per policy, for example, are determined by summing premiums for the month across the Tier 1 companies and dividing by the number of policies issued by Tier 1 companies in each month.

These metrics can also be calculated separately for new policies and renewing policies.

In the household insurance segment, these metrics can be further segmented for building only, contents only and combined building and contents policies.

²⁰ These premiums include ESL, but exclude GST and duty.



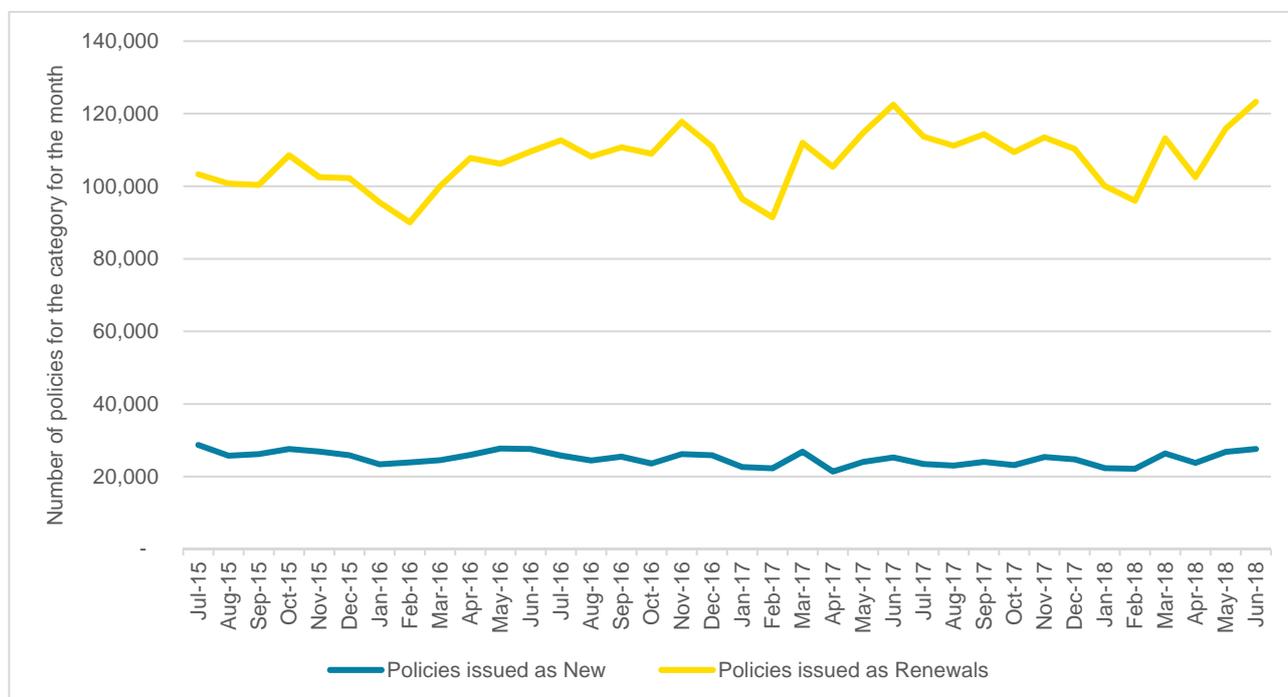
4. Observations and results

Our study analysed the pricing of new and renewal policies between July 2015 and June 2018. The analysis focuses only on combined home and contents insurance policies which are a subset of the broader household insurance class of policies. Only one company in the tier 1 sample was unable to separate combined home and contents policies, from building only and contents only policies. As this insurer is a major insurance company, we have nevertheless included its data for the purposes of this study.

4.1 Policy count

Over this period, the Tier 1 companies renewed on average 107,280 policies per month and issued on average 25,018 policies per month as new business. Policy renewals appear to experience some fluctuations over time whereas new business has remained relatively steady. On average, new business accounted for almost 1 in 5 policies issued each month (i.e. around 20%).

Figure 5: Number of policies issued, Tier 1 companies, Combined home and contents policies



Except for two insurers in the sample, the Tier 1 companies generally exhibit fairly stable month to month patterns in the policies issued. The dip around January 2017 is attributable to one major insurer whose data indicates that renewals halved from the previous month and fell further in February 2017. The dip in January and February 2018 is also attributable to the same insurer.

The Monitor also collects data relating to policies where refunds were provided, or were affected by endorsements and where policies have lapsed.²¹ As this monitoring study is focussed on new and renewing policies, this data has been excluded.

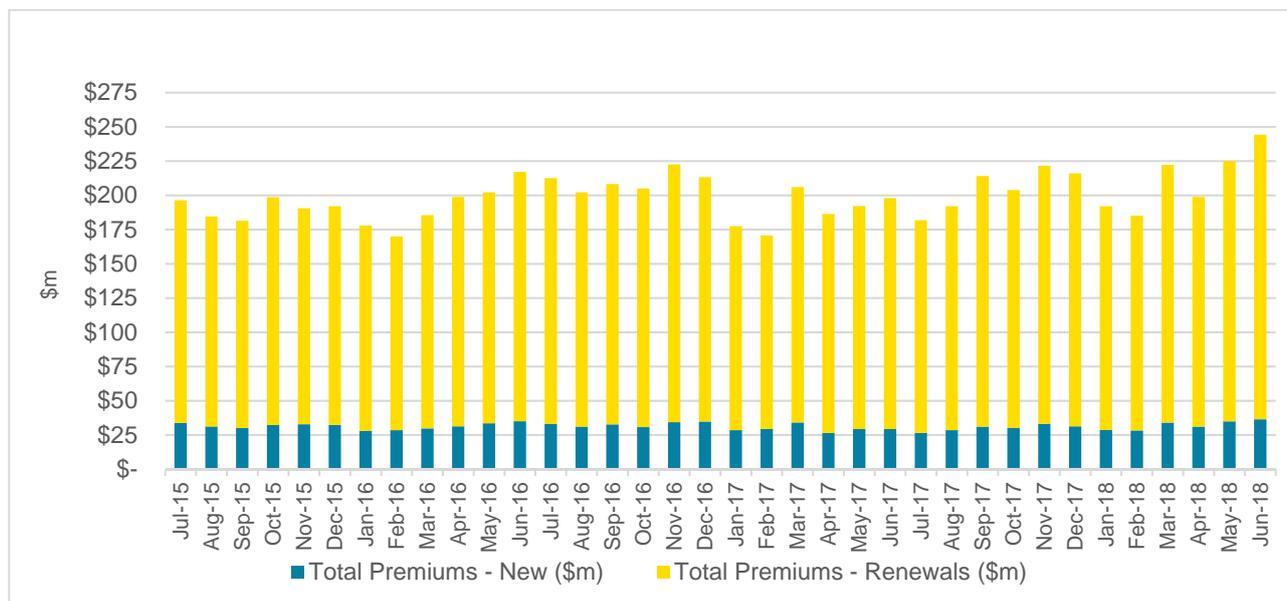
4.2 Total premiums

Total premiums represent the sum of base premium, the ESL, GST and duty. Figure 6 below displays the monthly total premium reported by all the Tier 1 insurers.

²¹ An endorsement is an amendments or change to an insurance policy which affects the scope of the policy. It can add, delete, vary, exclude or otherwise alter the coverage of the policy. Lapsed policies are those which have ceased or are discontinued, as a result of not being renewed or accepted by the insured.

Over the study period, total renewal premiums reported by Tier 1 companies ranged from \$141m to \$208m per month whilst total new business premiums ranged from around \$27m to \$37m per month.

Figure 6: Aggregate Monthly Total Premiums, Tier 1 companies, Combined home and contents policies



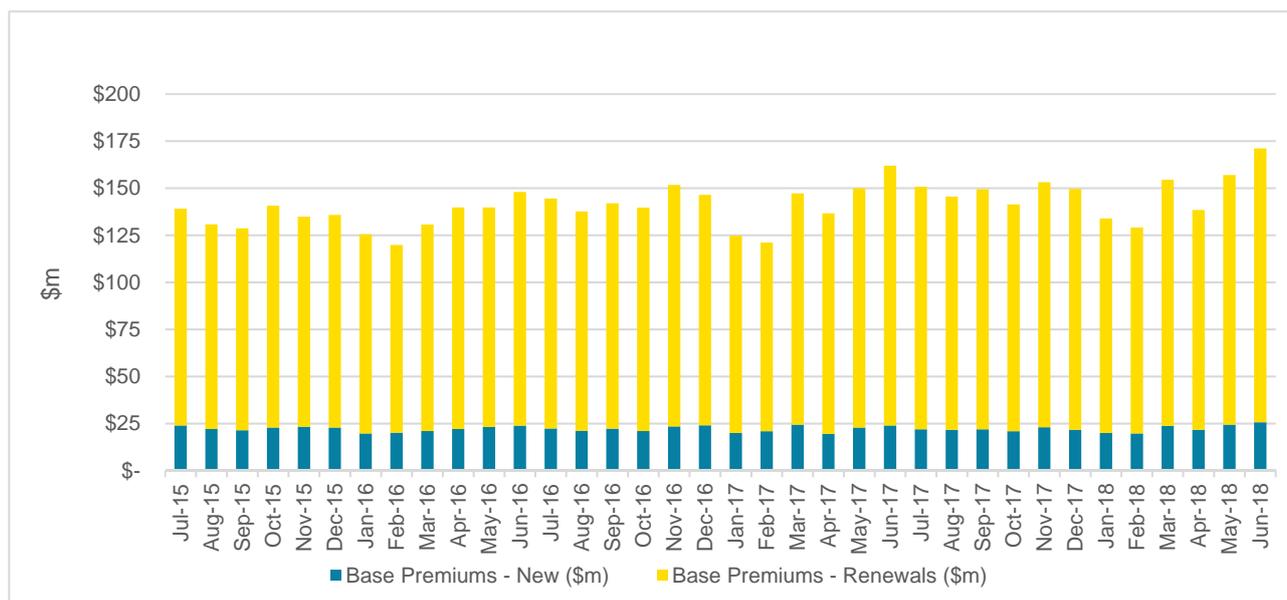
Some month-to-month fluctuation in total premiums is evident, with the months of January and February exhibiting slightly lower premium levels than other months of the year. Most of the fluctuations appear to be driven by renewals.

4.3 Base premiums

Base premiums represent premiums charged by Tier 1 insurers before the addition of the ESL, GST and duty.

Over the study period, base renewal premiums reported by all Tier 1 companies ranged from \$100m to \$145m per month whilst base new business premiums ranged from approximately \$19m to \$26m per month. As with total premiums, the data on base premium exhibits month to month volatility driven by the base premiums for renewals. Recent increases in the base premiums of renewals in the January to June 2018 period is evident.

Figure 7: Aggregate monthly base premiums, Tier 1 companies, Combined home and contents policies

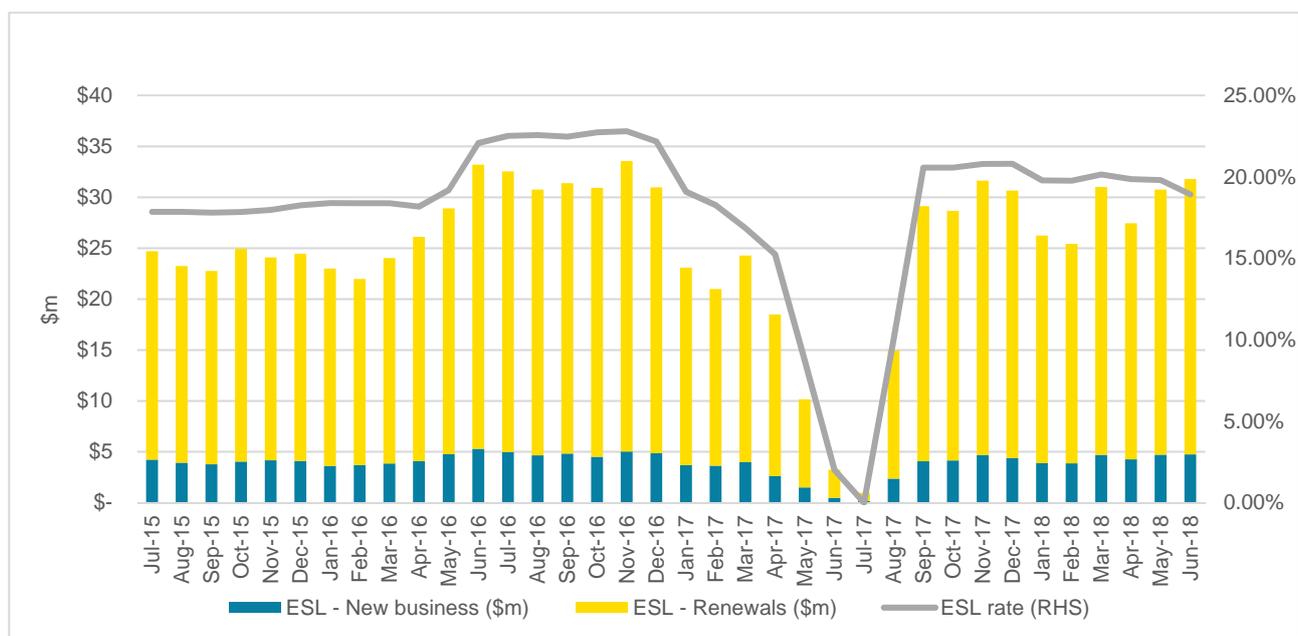


4.4 ESL

Figure 8 below displays the trend in aggregate dollar value of ESL collected from new versus renewal policies of all Tier 1 companies over the study period.

The highest levels of ESL collections are concentrated in the period June 2016 to December 2016, which coincides with the period when insurers were ‘tapering up’ ESL rates. The progressive reduction in ESL collections in the January to June 2018 period reflects the ‘tapering down’ of ESL rates which subsequently followed, ahead of the planned removal of ESL at the time. The sharp increases in ESL evident between July and September 2017 reflects efforts by insurers to re-establish ESL on insurance policies.

Figure 8: Aggregate ESL \$, Tier 1 Companies, Combined home and contents Policies



4.5 Average total premium per policy

Average total premium per policy is calculated as the aggregate total premium for all Tier 1 companies divided by the aggregate policy count for all Tier 1 companies. This metric is calculated separately for new policies and renewing policies.

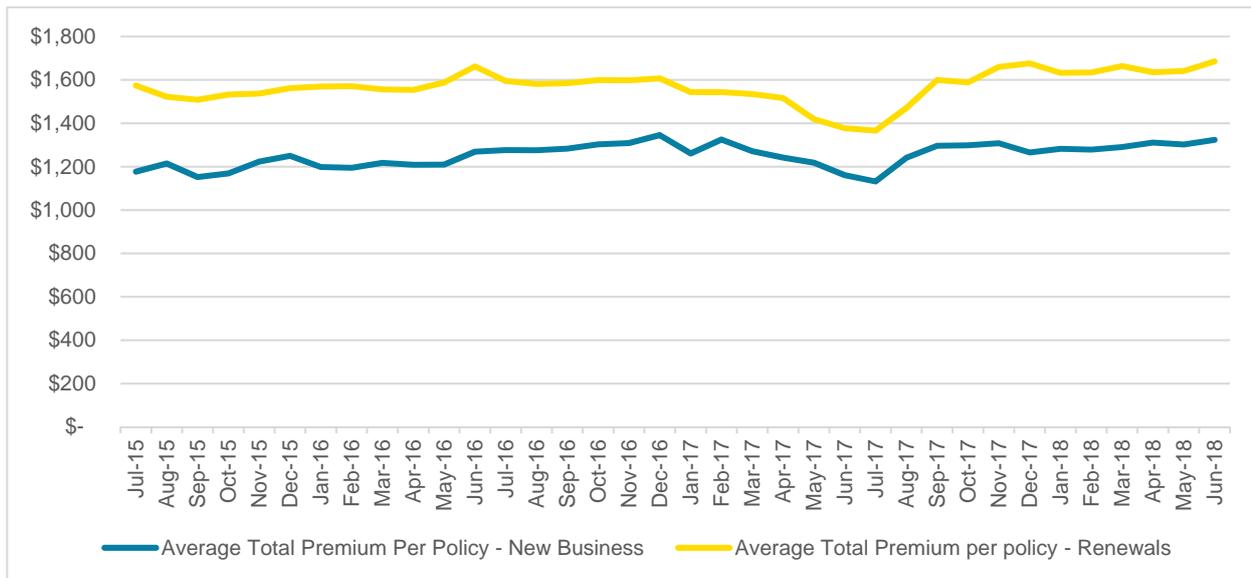
Figure 9 below charts the trends in average total premium per policy for new policies and renewing policies for the top 10 insurers in the combined home and contents insurance segment.

The analysis indicates that the average total premium for renewal policies is generally higher than for new policies. Since July 2015, average total premium per policy has ranged from \$1,366 to \$1,685 for renewals as compared with a range of \$1,132 to \$1,346 for new policies. The gap in average prices has fluctuated between \$201 and \$411 over the study period. Across the three years, average total premiums for renewals is approximately \$317 or 25% higher than that for new business.

The Monitor acknowledges that these observations reflect the average across all Tier 1 insurers, and it is possible that the pricing gap is attributed to some insurers and not others.

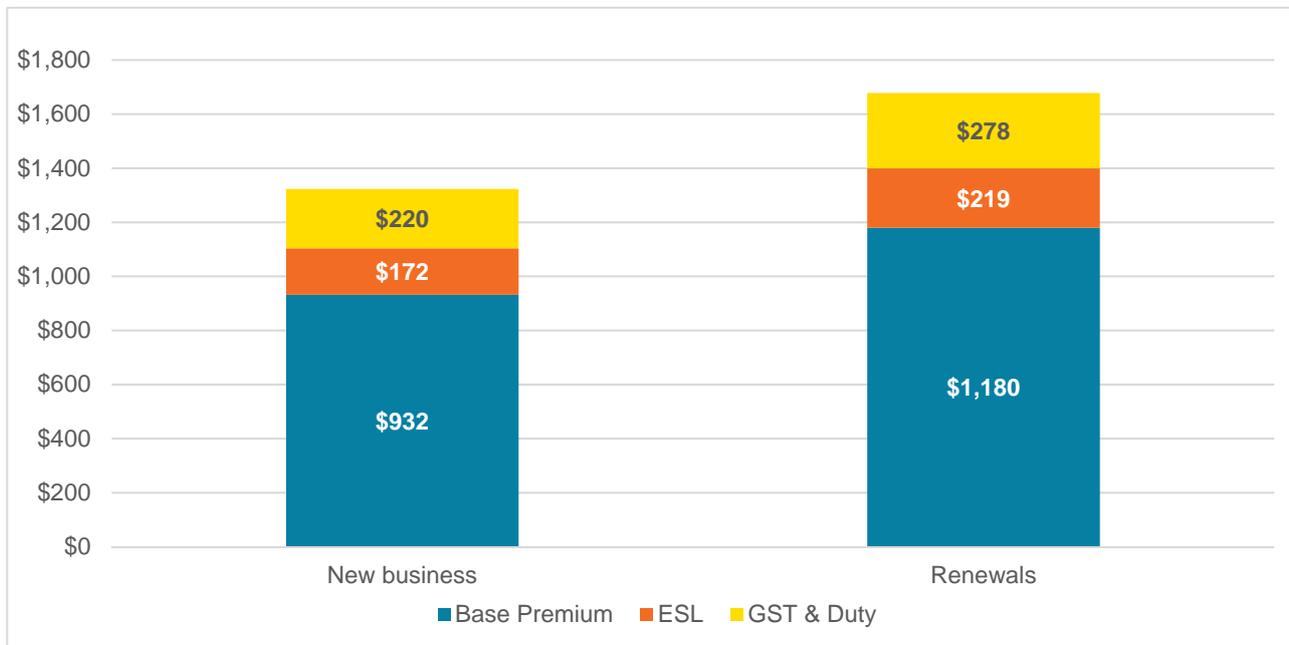
Given that total premium includes the ESL, the dip which is evident in the period leading up to June/July 2017 reflects the phased reduction in ESL as insurers planned for the full removal of ESL.

Figure 9: Household building & contents combined policies – Average Total Premium per policy, New business vs renewals²²



During the month of June 2018, average total premiums for policyholders who renewed was \$1,678 per policy compared with \$1,323 per policy for new customers. Renewing customers were therefore paying around \$355 or 27% more than that charged for new customers in that month. As the data on premiums relates to premiums received or earned, average premiums for renewals already reflect the impact of any loyalty discounts that the insurer may offer. That is, in the absence of any loyalty discount, the gap in average total premiums would be larger. The extent of the price gap also exceeds introductory discounts often provided for new customers, particularly those coming through online channels, which is often around 10%.

Figure 10: Household building & contents combined policies – Average Total Premium per policy breakdown (June 2018)²³



²² Top 10 insurers, combined home and contents insurance, NSW insurance policies.

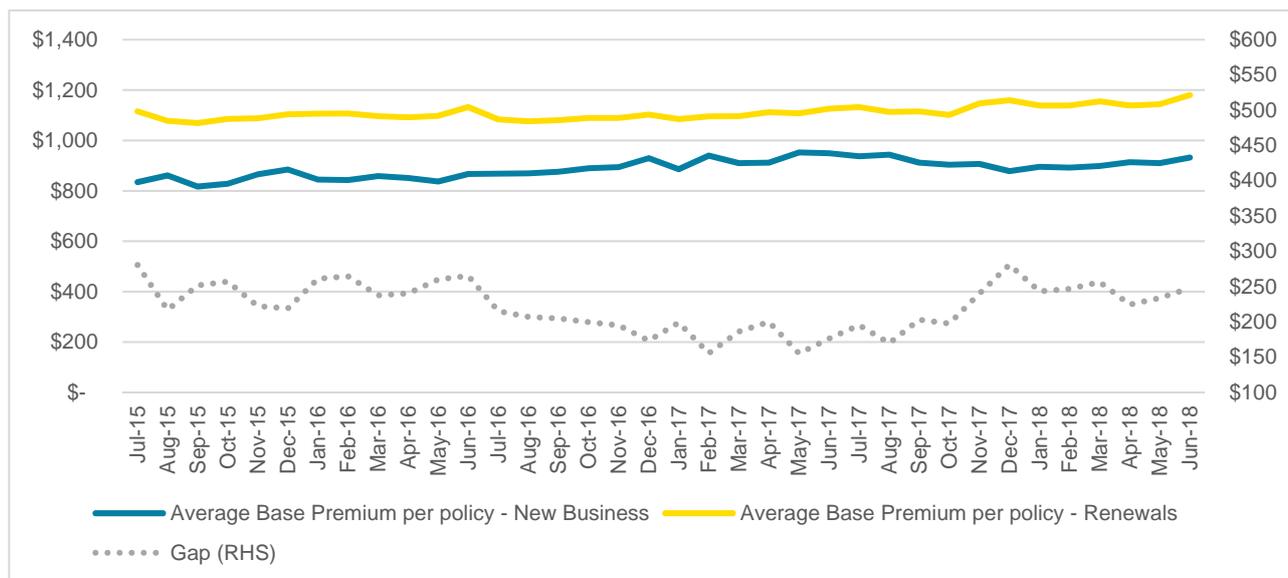
²³ Top 10 insurers, combined home and contents insurance, NSW insurance policies.

4.6 Average base premium per policy

It is apparent that most of the pricing gap between new and existing policies is attributable to the base premium component. The base premium reflects the price an insurance company is prepared to charge for a policy given technical risk considerations (e.g. the likelihood of a claim being made), operating costs that are to be recovered, required profit and commercial pricing adjustments. Commercial pricing adjustments reflect factors such as marketing and promotions, growth targets and response to competitor actions, which may raise or reduce the technical price.

Figure 11 below shows the trend in the difference in base premiums for new versus renewal policies over time.

Figure 11: Household building & contents combined policies – Average Base Premium per policy²⁴



It is evident that there is a consistent and positive gap between the base premium of renewal policies versus new policies. Across the three years, the average base premiums for renewals is approximately \$222 or 25% higher than that for new business. The size of the gap has fluctuated between \$155 and \$281 per policy, with the lowest gap occurring in the period from December 2016 to June 2017.

It is difficult to discern the underlying drivers of the pricing difference observed. On the face of it, it seems that insurers are collectively extracting higher margins from loyal insurance customers to attract new customers. However, there may be other factors that also drive the difference.

4.7 Adjusting for Sum Insured

The “sum insured” on a policy represents the financial limit of a policy – the maximum amount the insured is entitled to claim for repair or rebuild in the event his/her home (or insured item) is damaged or destroyed.²⁵ It therefore should reflect the estimated cost of rebuilding the insured’s property under a total damage scenario.

The policyholder is typically responsible for nominating the amount of sum insured on a policy. Many insurance companies provide web-based calculators to assist consumers in determining the appropriate level of sum insured²⁶ and may also use the figures generated by these calculators to ensure that the figure nominated by the policyholder remains within an acceptable range in order to minimise the risk of under-insurance.

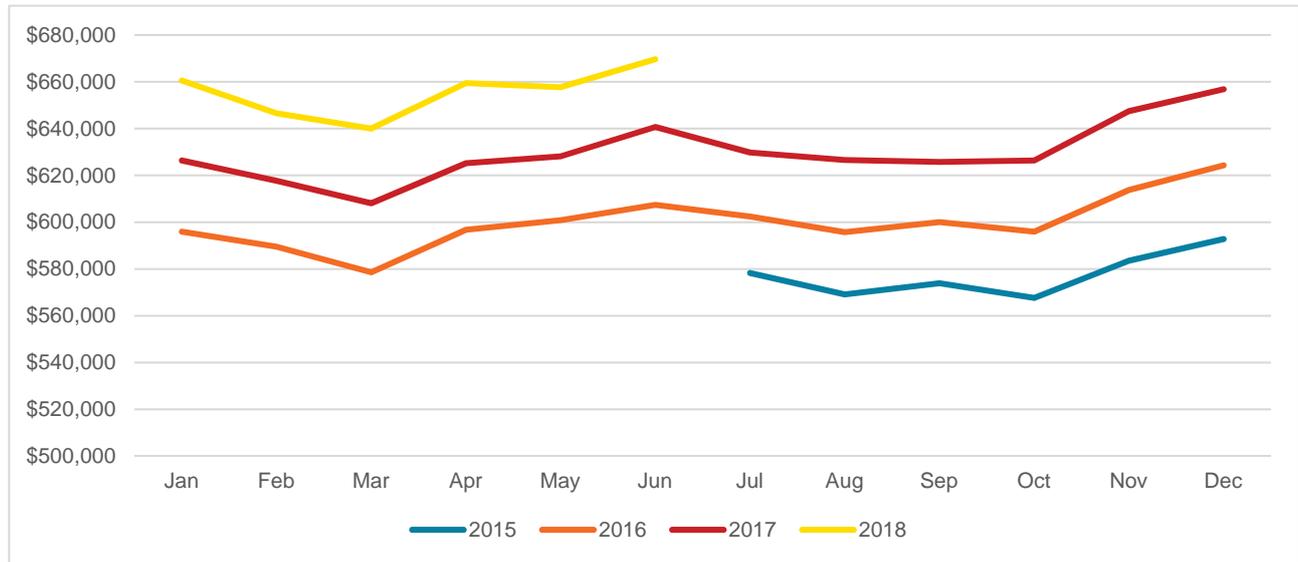
²⁴ Top 10 insurers, combined home and contents insurance, NSW insurance policies.

²⁵ Refer <https://www.moneysmart.gov.au/insurance/home-insurance>. Some policies do offer extended cover which may allow up to 30% on top of the sum insured value.

²⁶ A 2005 review by ASIC on home insurance indicated that there were often substantial differences in the results of web-based calculators of sum insured. Refer https://download.asic.gov.au/media/1348214/underinsurance_report.pdf

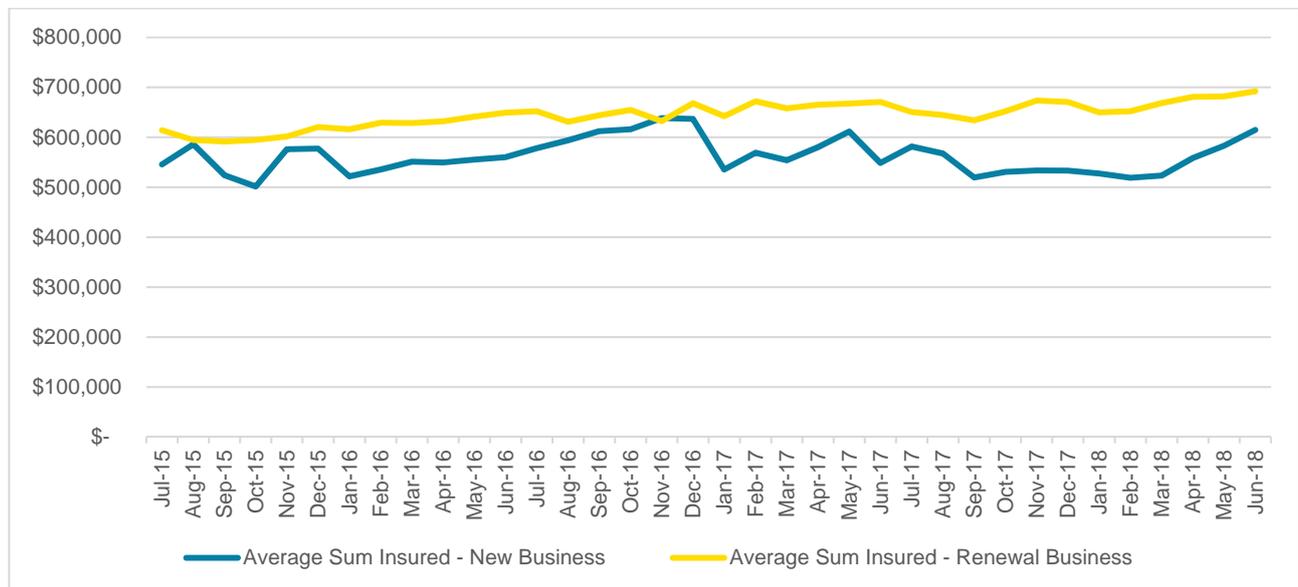
The Insurance Monitor understands that it is common practice for insurers to increase the sum insured on policies at the point of each renewal, to reflect escalating building and related costs. The data for one major insurer, which is shown below, illustrates this clearly.

Figure 12: Average Sum Insured per renewal policy (major insurance company)



Increasing the sum insured each year can be important as a way to avoid under-insurance, but over-insurance can also be a problem. Hence, the case for requiring automatic escalation of the sums insured on renewing policies should not go unquestioned. Nevertheless, putting aside the question of whether such an annual escalation might be reasonable, the Insurance Monitor's data does confirm that the average sum insured on renewal policies has mostly been higher than that on new policies in the past three years.

Figure 13: Average Sum Insured



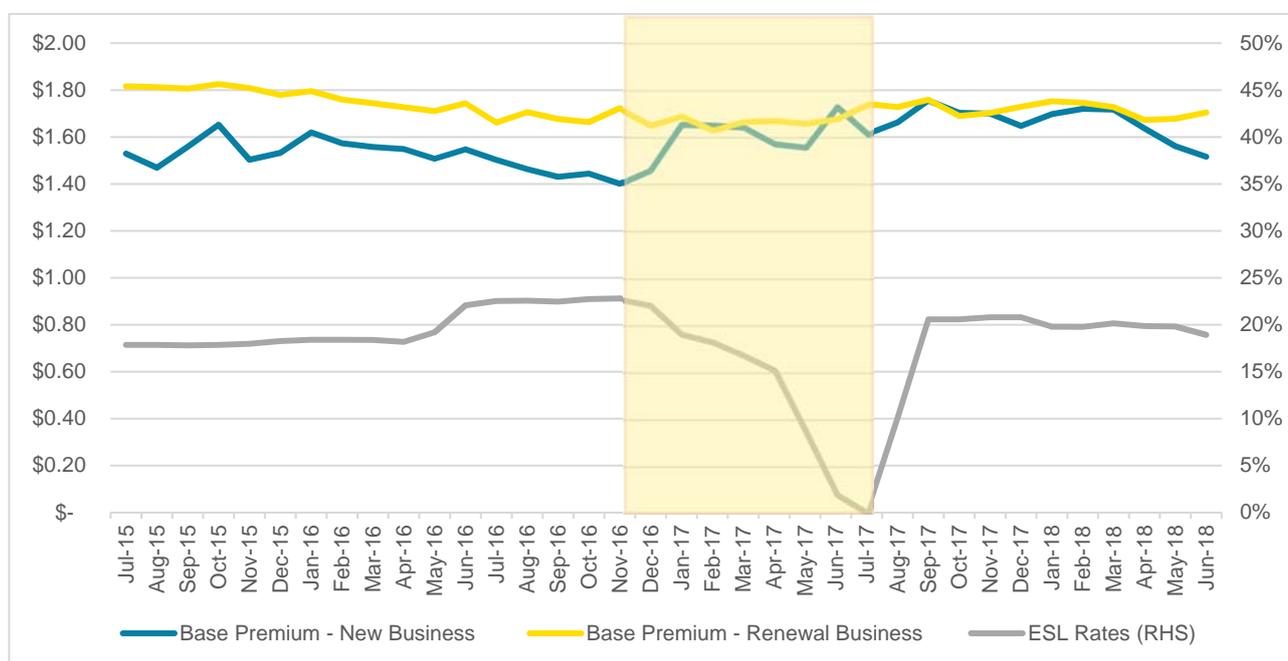
There seems to be a reasonable argument for adjusting for differences in sum insured in making the pricing comparisons in this study. However, whilst the sum insured is an important consideration from the perspective of the insured, the sensitivity of changes in this variable to the cost of supplying insurance is not known precisely. It is conceivable that the sum insured would be a material driver of the price of home and contents insurance in cases where the relevant property is located in a region where there is high risk of total loss or write-off (e.g. due to natural disasters such as hurricanes or flooding). This, however, would only be the case

for around 2% of properties in NSW.²⁷ We also note that the UK field study conducted by the FCA (referred to in Section 3 of this Discussion Paper) did not explicitly refer to an adjustment of this nature.

Nevertheless, Figure 14 below shows the pricing difference after adjusting for differences in sum insured. This is done by calculating the average base premium per \$1000 of sum insured for both new and renewal policies so both are expressed as a price per \$1000 unit of sum insured. It is evident that the pricing gap remains but varies over time. Renewing customers were charged higher base premiums than new customers between July 2015 and January 2017 on a price per \$1000 of sum insured measure. During this part of the study period, the average base premium per \$1000 of sum insured on renewing and new policies was \$1.72 and \$1.58 respectively, a gap of around 14.5%.

Between January / February 2017 and March 2018, the gap more or less closed, but recently, it has returned to around the levels previously seen. Across the entire three year study period, the average pricing gap on a price per \$1000 of sum insured was 9.1%.

Figure 14: Household building & contents combined policies - Average Base Premium per \$1,000 of sum insured & ESL rates²⁸

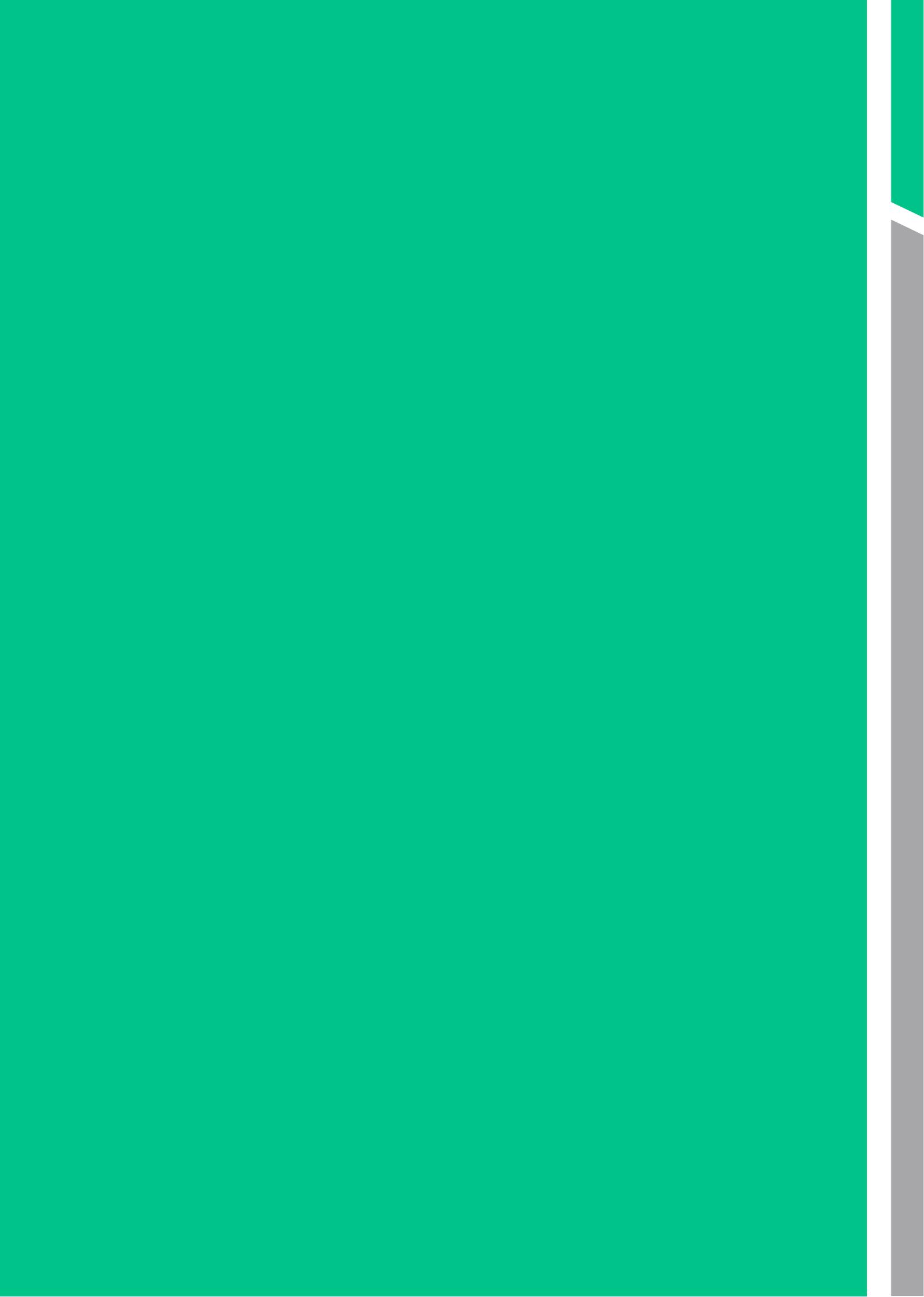


It is evident that the upward trend in the price of new business policies commenced around November 2016 and continued until September 2017. The majority of this period coincides with the time that ESL rates were being phased down ahead of the originally planned removal of the ESL by 30 June 2017.

The results for the period to June 2017 are of concern to the Monitor. They suggest that Tier 1 insurers apparently increased their pricing of base premiums for new business coincidentally with the reduction in ESL rates that was occurring between November 2016 and June 2017. Further analysis will be undertaken at the individual insurer level to determine the significance and implications of these findings.

²⁷ <https://www.choice.com.au/money/insurance/home-and-contents/articles/flood-cover>; <https://www.smh.com.au/business/costs-soar-for-reinsurers-20130217-2el7q.html>

²⁸ Calculated as aggregate of base premiums for top 10 insurers divided by aggregate sum insured of top insurers multiplied by \$1000.



5. Next steps

The Monitor acknowledges that the findings from this study reflect the average results across all Tier 1 insurers, and it is possible that the pricing gap identified may be attributable to some insurers and not others. The Monitor is intending to conduct further investigation and analysis of the data and findings from this study at the individual insurance company level. To enable this, further enquiries may be made of insurers and data at a more granular level may be requested.

The Monitor will have regard to any further information that insurers, policyholders and others may choose to provide in their submissions in response to this Discussion Paper that may assist with the Monitor's further investigation. Regard will also be given to the information obtained from insurance companies in relation to the issues on the standard profile quotes relating to renewals.

One of the general outcomes of such further analyses may be a review of the current Guidelines in relation to the prohibition against price exploitation, and false or misleading conduct, to determine whether any amendments are required to address the matters outlined in this Discussion Paper.

General enquires about this paper should be directed to:

consultation@eslinsurancemonitor.nsw.gov.au

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