Bankhall

FCA Market Study: General Insurance Pricing Practices

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Introduction and background

The FCA has issued an interim report following a market study into the pricing of home and motor insurance.

The market study looked at whether pricing practices in home and motor insurance support effective competition and lead to good customer outcomes. The FCA have stated that it is important this sector works well and delivers good customer outcomes. The market study followed on from a Thematic Review showing that consumers who stayed with same provider for a long time paid significantly more on average than newer customers.

Key points

The Thematic Review found that Markets were not working well for consumers. Complex pricing practices were being used allowing firms to raise prices for consumers that renew year on year with the same firm. This is called "price walking", and this practice is not made clear to consumers. Further FCA research shows that consumers think this practice is wrong.

Other key issues that the review identified include:-

- Insurers often sell policies at a discount to new customers and increase premiums when customers renew, targeting increases at those less likely to switch;
- 6 million policy holders paid high prices in 2018. If they paid the average for their risk they would have saved £1.2bn;
- Longstanding customers pay more on average but loyalty is not the only issue – high prices were paid by some consumers who had been with their provider for less than 4 years;
- FCA Research identified 1 in 3 consumers who paid high prices showed at least one characteristic of vulnerability, such as having low financial resilience or capability;
- People who pay high premiums are less likely to understand insurance or the impact that renewing has on their premium;
- Most firms, when setting a price, include their expectations of whether a customer will switch or pay an increased price. This is not made clear to the customer;
- Firms engage in a range of practices that could make it more difficult for consumers to make informed decisions and could raise barriers to switching; and
- Many consumers who switch or negotiate their premium can get a good deal.

The FCA is considering a wide range of remedies to address these issues which are covered in full in the detailed analysis under the "Actions the FCA is considering" sub section.

Next Steps/Actions for firms

Many of the issues identified in this study are focused on the practices of general insurance providers and intermediaries with premium price setting powers.

However, there are some issues which will be of relevance to all general insurance intermediaries whether they price set or not. This includes any support the firm provides with the renewal process and whether it highlights any savings that may be obtained. Also, how the firm assists vulnerable customers given that these are some of the consumers who have been identified as being most at risk to paying higher costs for insurance.

The FCA will conduct further analysis of the issues highlighted in the report to inform the final market study report. In particular the FCA will look at:

- Why some new customers and those with shorter tenures pay higher prices.
- The potential remedies the regulator propose focusing on and the associated costs and benefits with each.

Responses to the interim report should be sent to the FCA by 15 November 2019. The regulator intends to publish a final report and a consultation on the remedies it will take forward in Q1 2020.

Detailed analysis

Market overview

Over 45 million home and motor insurance policies were written in 2018 with 82% of UK adults having one or more general insurance products.

Often consumers buy insurance from an insurer or intermediary after comparing prices on a Price Comparison Website (PCW). Sales through a PCW account for 13% of all home insurance policy sales. Consumers undertake different degrees of search at renewal, some search extensively for the best deal each year others periodically or only when the renewal reaches a certain price. Some renew without shopping around at all. 72% of home insurance respondents said that they undertook 'active' forms of search. More than half (52%) reported that they used two or more forms of search activity. 12% reported renewing automatically without doing any research.

General Insurance business models can vary across the supply chain, but fit broadly into the following categories:

- The insurer may set the retail price that consumers pay.
- The insurer may set a net rated price, with an intermediary setting the retail price consumers pay.
- The insurer may delegate authority to an intermediary to set the net rated price and the retail price.

General insurance pricing is increasingly using customer data. This could lead to benefits for consumers e.g. allowing more accurate pricing and the ability to offer insurance to consumers traditionally seen as too risky. However, it could also lead to some customers being considered too risky and becoming uninsured. Could also allow firms to identify customers who are less likely to switch and to charge these individuals higher prices.

The FCA estimates that 1 in 5 combined buildings and contents customers are paying high margins (a premium that is 50% above the market average premium for their risk). 1 in 10 is paying very high margins (a premium that is double the market average for their risk).

Consumers see price as the most important reason for choosing a provider, although brand is a contributory factor. There is less engagement with the non-price elements of a policy due to a lack of available information for consumers to make decisions about quality.

On average, home insurers receive £231 in premium policies per year. This accounts to around £8 per policy in core product underwriting profit as calculated using firms' financial data submissions. When including revenue from non-core sources, such as add-ons and investment income, the overall profit rises to £25 per policy for home insurance. Direct and PCW only insurers have a higher proportion of add-on revenue compared to the other firms.

Intermediaries earn on average higher operating profit per policy than insurers. Home insurance intermediaries in the FCA's sample earned on average £58 per policy, resulting in an average per policy profit of £39. Home insurance intermediaries earn 25% of total revenue from non-core revenue. Legal expense cover is the largest component of add-on revenue for home insurance intermediaries.

How firms set prices and treat their customers

Most firms adopt pricing practices that set different prices at new business and renewal. Most firms operate a price walking strategy, selling to new customers at a discount and increasing cost at renewal. This can lead to significantly higher prices for renewing consumers after a few years, compared to new customers. This can be regardless of the cost to supply insurance. The majority of firms in the FCA's sample use some form of cap to limit how much prices charged to individual customers can rise above costs.

The main reason for increasing cost at renewal is to recoup losses incurred giving introductory discounts to new customers, sometimes at below cost. This practice is not always apparent to customers.

Firms adapt the margins they aim to earn on individual consumers. The main models the FCA has seen:

- Conversion models - These assess the number of sales of both core policy and ancillary products compared to the number of quotes at new business.
- Retention models – These assess the expected number of sales of both the core policy and ancillary products compared to the number of quotes at renewal. Firms then anticipate the expected impact of price changes on customer retention.
- Ancillary product models. Firms offer ancillary products or premium finance alongside a core insurance policy.

These margin optimisation methods are used for both new business and renewal pricing. Whilst margin optimisation can be profitable for an individual firm, it does not necessarily benefit consumers. Consumers who are more price sensitive pay less, whilst those who are less price sensitive pay more. This is a form of price discrimination.

Firms apply risk rating factors to data on customers' risk characteristics to calculate the expected claims cost. The number of ratings factors firms use on their customers ranges from 50 to 400. Among the factors used by firms to set final price or optimise margins were the following:

- Factors also used for pricing risk e.g. does the property have smoke detector, policyholder age, the number of children in the family.
- Factors unrelated to risk e.g. occupation, where they shop, what else they buy.
- Factors relating to customer's buying and media habits e.g. browser type, time of day and the month of purchase.
- Factors relating to credit scores, including credit search history.
- The type and level of cover purchased, including whether a home policy includes accidental damage and whether the policy auto renews.
- The insurance brand chosen by the customer.

Customers may not always be aware of how their personal data and data from external sources are used in calculating the price of their policy.

Vulnerability can be difficult to identify in this market as contact tends to be annual. Certain factors are used by some firms to indicate potential vulnerability e.g. age, whether there has been a switch or a negotiation in recent year. Some firms may then freeze prices where a customer is temporarily in a weaker position.

Treatment of legacy customers

Some customers hold policies that are no longer sold to new customers. There can be significant differences in price between legacy products and those sold to new customers. This can be because legacy customers with long tenure can be less price sensitive and less likely to shop around.

Firms tend to have limited information on customers with legacy products the firm no longer sells, as a result firms may price walk these customers using common increases every year. This could mean these customers pay much higher prices than if they were switched to a new product with equivalent cover.

Several firms have recently started to review their legacy products and have instigated projects as follows:

- Migrating all legacy customers onto new products through brand consolidation.
- Suspending interest on instalment payments.
- Offering new business prices to all customers on closed products, while matching the existing terms and conditions of the legacy policy
- Implementing a target operating ratio to align all back-book customers with new business practices.

Price negotiation at renewal

When consumers receive their renewal invitation, some firms are open to negotiation on price if their customer contacts them. Other firms have a policy of a single renewal offer with little or no room for negotiation.

Firms allowing customers discounted renewal prices have procedures that control how much discretion is allowed e.g., front-line staff can offer a system generated discount, where the decision is based on factors including the renewal premium price, number of additional products held and the customer's lifetime value.

One firm takes customer retention into account when setting the performance objectives of customer service staff.

Auto renewal

Many policies contain auto-renewal clauses, meaning that unless a customer tells the firm otherwise the contract will renew automatically. Customers can still renegotiate, amend, switch or cancel their cover up to renewal date. Many firms emphasise the importance of auto-renewal in ensuring that customers are not left uninsured.

Most auto-renewals seen by the regulator were on an opt-out basis, meaning customers have to make an active choice to opt-out of this. To cancel auto-renewal policies most policies require contact by phone, even if the policies were originally taken out online.

Some firms charge higher prices to auto-renewal customer. The FCA is concerned that some customers' auto-renewing may not be aware that choosing this path could lead to higher premiums in the future.

The impact of pricing practices on competition

Not every consumer benefits from an increase in competition. Additionally, price competition can also increase the average price paid by consumers. Consumers who are more willing or able to switch brands pay lower prices than those with higher switching costs or a stronger preference to remain with their current brand. Some consumers may not be aware that they are not getting competitive prices and not feel the need to shop around.

Strong evidence found showing that consumers who pay the highest margins are, on average, the least aware of how pricing practices in the home and motor insurance markets work. These customers are also least aware of how competitive their current deals are. Lower income consumers (below £30k) pay higher margins than those with higher incomes when purchasing combined home and contents insurance.

Consumers can end up paying higher prices where they:

- Lack financial knowledge or access to the internet and so do not or cannot easily shop around to check they are being offered a competitive price.
- Trust their current firm to offer a competitive price and so do not see any need to shop around.
- Do not engage in decision making for a variety of reasons e.g. because they intend to search but forget, lack awareness about the potential benefits of shopping around for a better value deal, or they just lack confidence to do so.

An increased use of data could be beneficial for consumers if they choose to share it with providers who could help them shop around and switch to better deals. It may also allow for more accurate pricing for individuals. However it could also widen price differentials between consumers who actively switch and those who don't.

Vulnerable customers

1 in 3 consumers paying high prices showed at least one characteristic of vulnerability e.g. low financial resilience or capability.

Consumers who are vulnerable in two or more characteristics are more likely than average to be unaware of pricing practices in insurance. The FCA are concerned that vulnerable customers may be unable to benefit from lower margin products and may be more likely to drop out if their premiums rose.

The FCA's concerns

The FCA is concerned about firms' price discriminating based on consumer awareness.

- Consumers who are less aware of how pricing works pay higher prices. These consumers include those who have less financial knowledge, no internet access, and who trust insurance firms to offer them competitive prices.
- High costs are imposed on consumers and firms, and this is likely to raise the price of home and motor insurance overall.
- Consumers may fail to search and switch when it is in their economic interest to do so. A substantial minority of consumers are unaware that renewal prices will often be higher or not as competitive, these customers may struggle to find low margins and this could limit their access to insurance.

Additionally the regulator is concerned about:

- Firms using complex and opaque pricing techniques to identify consumers who are more likely to renew and they can earn higher margins from.
- These consumers are given higher renewal quotes.
- Firms' practices discourage shopping around.
    - Some consumers rely on auto renewal and don't switch or negotiate price
    - Some consumers don't research their options and so pay more.
    - Some consumers spend significant effort shopping around to get a competitive price.

Although industry has been taking some steps to address the issue, the regulator thinks that further intervention is required.

In the immediate term, the FCA will be looking to:

- Ensure firms improve governance, control and oversight of pricing practices.
- Deliver the changes required from firms following implementation of the IDD.
- Continue to improve transparency and engagement at insurance renewal in addition to the new rules were added in 2017.

Actions the FCA is considering

The FCA will monitor how firms could change their business models in response to potential remedies e.g. reducing the quality of core business models or increasing the sale of add-ons to consumers that may offer little additional value. These would also result in poor outcomes for consumers. Good governance over pricing outcomes for consumers should be central to firms' pricing practices.

The outcome of any future intervention on different consumers will be considered e.g. many consumers can get lower prices if they actively shop around and switch. The FCA is not looking to remove these benefits for these customers.

Remedies to tackle high prices for consumers not switching or negotiating

Supply side remedies being considered by the FCA are:

- Limiting practices that allow firms to charge higher prices to consumer who don't switch e.g. restricting or banning margin optimisation based on the likelihood of a consumer renewing. This could include the following:
    - Restrictions on price increases to renewing customers e.g. allowing firms to set discounts for new customers but not permitting any future increases in margins beyond the first year if these customers renew or banning price walking as a strategy for general insurance.
    - Restrictions on the use of particular factors in setting prices and determining margins e.g. the consumers' likelihood of switching or negotiating a better deal.
    - Restrictions on the price level relative to a benchmark such as the new business price for the policy.
- Automatic switching of consumers paying high prices to lower priced products providing equivalent cover to help combat price walking.
- Requiring firms to engage with customers to give them information about alternative deals and identify those who may need help in moving to better priced products with equivalent cover.
- Expanding or strengthening existing product governance requirements.
- Requirements for firms to provide data tracking their actions to improve pricing practices and monitoring pricing differential between customers.

Remedies to address practices which could discourage switching

To address concerns that auto-renewal is being used in ways that could discourage some consumers from switching the FCA is considering the following potential remedies:

- A ban or restriction on the use of auto-renewal of insurance policies, including where there has been a change in the price.
- Making auto-renewal opt-in only.
- Making it easy to decline auto-renewing policies at the time of purchase and at renewal.
- Ensuring that firms make it as easy to exit a contract as it was to sign up.

The impact on the advantages of auto-renewing insurance will be considered. Auto-renewal provides benefits for some consumers e.g. those who wish to renew with their existing insurer. It also protects those who have forgotten to renew their insurance from becoming uninsured.

Strengthening product governance rules

The regulator will also look at changing existing rules on product governance. The current rules include a requirement for firms to consider whether the costs and charges of the insurance product are compatible with the needs, objectives and characteristics of the target market. The rules apply to products manufactured, or products where there has been a ‘significant adaptation’ after 1 October 2018.

The existing requirements could be expanded to:

- Apply the requirements to all products, not just those manufactured or significantly adapted after 1 October 2018.
- Requiring firms to consider the value of the contract to the target market over time.
- Include a responsibility for a senior manager to take responsibility for the value of products to the target market.

Remedies to improve the clarity and transparency of firm-customer interactions

The FCA sees this as key to well-functioning markets. The FCA doesn’t see providing more information to customers as the only solution to the concerns we have identified in this market study. However ensuring that firms are clear and transparent with their customers is likely to reinforce and support the overall package of remedies.

To further improve transparency the FCA is considering:

- Requiring firms to be more transparent about their pricing strategies and he reasons for price increases.
- Requiring firms to publish information about their price differentials between their customers. This may increase competitive pressures and public scrutiny that could prompt firms to improve their pricing practices.

Increasing public scrutiny of firms pricing practices

The regulator will look at whether firms should be required to publish information about their pricing practices or differences in prices between customers of equivalent risk. Publishing such information could lead to public scrutiny and pressure on firm prompting them to lower prices. It may also prompt consumers to consider the prices they are charging, how these prices may have changed over time and whether they should switch.

Long term reform of the market by harnessing the benefits of innovation

The FCA will also look into the ways in which retail general insurance markets could be positively affected by future developments and innovation. Developments such as Open Finance and the increasing use of consumer data have the potential to transform the way consumers interact with financial products. Currently PCWs help consumers shop around and compare prices. However consumer need to actively provide their data to benefit fully from these services. The FCA believes that Open Finance has the potential to revolutionise the way financial markets work for consumers, delivering significant consumer benefits and spurring better competition and more innovation.

The FCA are considering further work on uses of data and analytics across sectors and will communicate more details in due course. The regulator will include general insurance within wider work on Open Finance currently taking place.

Remedies not considered

The FCA has confirmed that the will not be looking at the following:

- Requiring multi-year contracts, the FCA doesn’t believe that increasing contract lengths will address the issues.
- Requiring a single switching and renewal period for all consumers, other countries have attempted this and evidence suggests that it led to consumers being less motivated to switch.