Senate Economics References Committee

Inquiry into Australia's General Insurance Industry

Submission by

Allianz Australia Insurance Limited

Allianz welcomes the opportunity to make a submission to the Committee's inquiry. Allianz has not sought to respond to the whole Terms of Reference (ToR). In this regard, Allianz supports the submission of the Insurance Council of Australia. Allianz's submission seeks to respond to ToR(e), specifically, "the costs…associated with the establishment of an independent home, strata and car insurance comparison service in Australia".

Background

Allianz's submission focuses on the establishment of a mandatory comparison site for home and motor insurance.

Allianz does not believe it is technically or practically possible to establish a comparison site[1] for residential strata insurance. Strata insurance policies are generally purchased by a body corporate manager or representative through an insurance broker and/or a specialist strata insurance underwriting agency. With limited exceptions, strata insurance is a commercial insurance product that is manually underwritten with the premium and cover tailored to the needs of each specific strata property. It is not possible to automatically generate a premium for the purposes of comparison by a strata manager/owner answering a limited number of questions on a price comparison site. This submission, therefore, concentrates on the implications, particularly for consumers and competition, of a mandatory comparison site for home and motor insurance.

[1] That is, a comparison site on which consumers could compare precise premiums from a range of insurers in real-time.

Impacts of a mandatory insurance comparison site

As indicated, Allianz's submission focuses on the impacts of a *mandatory* national general insurance comparison site. Commercially-based voluntary comparison sites already exist in the market and insurers that wish to participate in them are open to. Allianz chooses not to participate in commercial comparison sites in Australia. They charge a fee for their service and therefore impose an unnecessary additional distribution cost that would need to be passed on to our customers in the form of higher premiums. Comparison sites also dilute the brand and business relationship Allianz seeks to build with its policyholders.

Allianz is of the view that a mandatory national comparison site for home and motor insurance would result in adverse consequences for many insurance customers and, in the medium to longer term, less competition in insurance markets. Specifically, a mandatory national insurance comparison site for home and motor insurance would likely result in:

- **higher prices for consumers with high risk profiles**, such as those exposed to extreme natural perils (eg cyclone, flood and bushfire), but also, for example, young drivers and those living in areas with high levels of burglary and theft; and
- unsustainably low levels of profit, or more likely, losses for some (particularly smaller) insurers, leading over time to some insurers ceasing to sell the types of insurance on the comparison site or even ceasing to operate altogether, leading to **industry consolidation, greater market concentration and a reduction in competition**.

Discussion

Principles of insurance

Pooling risk

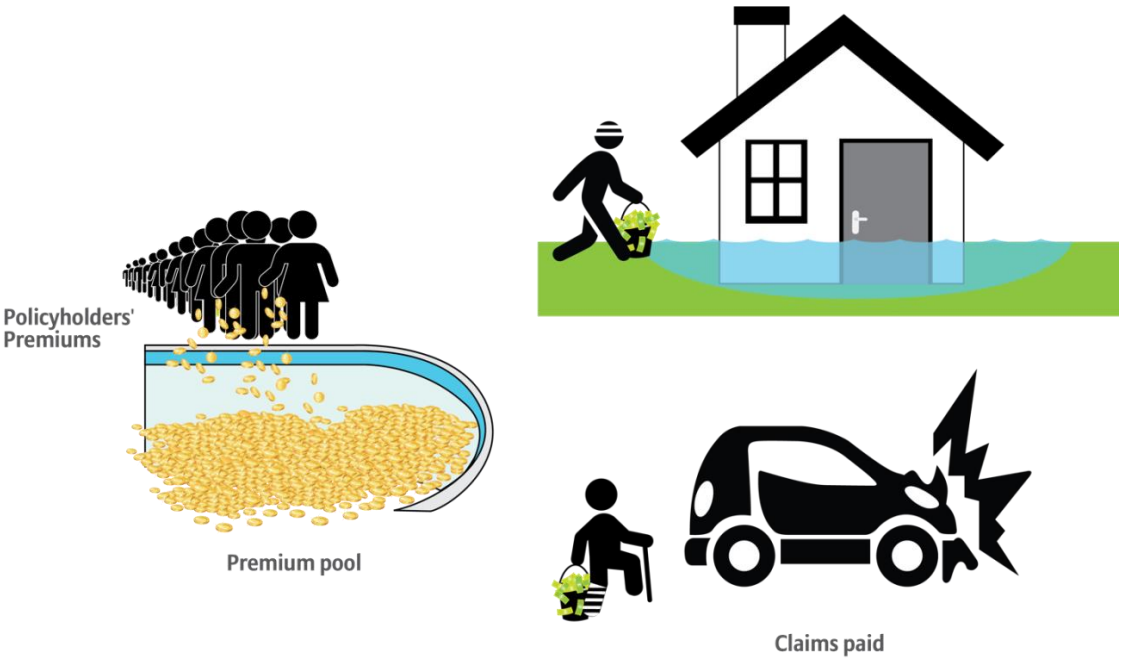
Insurance is based on the principle of pooling risk. That is, a large number of policyholders pay a relatively modest premium into a 'pool', out of which is paid larger amounts of money to a relatively small number of policyholders that make a claim during the period of insurance, which is normally 12 months.

A basic, but difficult, task of an insurer is to calculate the size of the premium pool that will be required. To do this, insurers need to estimate how many claims might be received (the claims 'frequency') and what the cost of those claims will be (the claims 'severity').

For 'short tail' insurance[2], the objective is that, in each year, the premium 'pool' collected by an insurer (eg for car or home insurance) is sufficient to pay the claims made by customers, as well as to cover the operational and other costs (eg commissions paid to intermediaries) of running the insurance company, including a fair and reasonable profit (out of which is paid a return to shareholders).

For 'long tail' insurance, that is, where most claims costs are paid in the years after the claim is made or the loss occurs (eg personal injury and liability insurance), insurers not only need to charge a premium sufficient to cover the running costs of the business but also to put aside reserves, out of which claim payments in subsequent years can be made.

Figure 1: Insurers collect a 'pool' of premiums out of which claims are paid



[2] 'Short tail' insurance refers to policies where the premiums received and related claims are generally paid within the same 12 month period (eg home and motor insurance). 'Long tail' insurance refers to policies where the claims are received and/or largely paid in the years after the period of insurance in which the premium was received (eg motor injury (CTP) and liability (public liability, professional indemnity) insurance).

Spreading risk

Insurance is also based on the principle of spreading risk across policyholders with different risk profiles. For example, insurers will seek to spread their risk geographically, for example, so they don't have a concentration of home insurance policyholders in areas particularly vulnerable to natural perils (eg flood, cyclone or bushfire). For instance, no insurer would want to insure every house on the banks of the Hawksbury River (flood risk), in North Queensland (cyclone risk) or in the Adelaide Hills (bushfire risk). Insurers avoid such situations because they create what insurers call 'concentration risk'.

If an insurer is over-represented in an area vulnerable to a particular natural peril, then it will be more adversely impacted than its competitors when such an event occurs. To protect itself against such a risk an insurer would need to increase its level of reinsurance[3] protection. This would add to the insurer's costs[4] and necessitate an increase in its premiums to return its premium pool to its target level of profitability.

Insurers may also seek to spread their risk according to other, non-geographic, risk characteristics. For example, across different age groups, so they don't have a concentration of motor insurance policyholders that are young, inexperienced drivers. Insurers put in place distribution and pricing strategies to ensure they spread their risk according to their risk appetite.

Setting insurance premiums

Community rating – all policyholders pay the same or similar premium

One option for setting the premium to be paid by each policyholder would be to divide the total amount of the required premium pool by the number of policyholders and, taking account of different levels of insurance cover, charge each policyholder the same 'rate' (ie cents per dollar of insurance cover)[5]. Put another way, charge each policyholder a 'weighted average' premium, where the weighting is based on the amount of insurance cover provided under each policy (eg the different sums insured of customers' houses).

[3] Reinsurance is insurance that is purchased by one insurer from one or more other insurers and comes in many forms. A common one is 'catastrophe' reinsurance, which is used to protect an insurer against the impact of an unexpectedly large number of claims arising out of a catastrophic event (eg an earthquake).
[4] The Australian Prudential Regulatory Authority (APRA) also recognises this risk and applies an Insurance Concentration Risk Charge, which can increase the amount of capital an impacted insurer needs to hold, which will also increase the insurers cost base.
[5] Insurers call this the 'Rate on Line' (ROL), one version of which is a percentage derived by dividing the premium by the limit of the insurance cover. For example, a premium of $1000 for a car insured for $20,000 would have an ROL of 5%.

This approach is sometimes referred to as 'community rating'. In Australia, governments regulate some private insurance markets to achieve, to a greater or lesser degree, a community rated premium, for example, private health insurance and compulsory third party (CTP) motor accident injury insurance (eg Victoria's Transport Accident Commission and Qld and NSW CTP).

Figure 2: Community rating – all policyholders pay a similar premium irrespective of risk

Community rating is not possible in an unregulated insurance market where policyholders have different risk profiles. That is, where some customers have a higher risk of making a claim than others. Charging all policyholders the same rate, irrespective of their risk profile, would result in lower risk customers being overcharged and higher risk customers being undercharged, relative to the amount of 'risk' they bring into the overall insurance 'pool'.

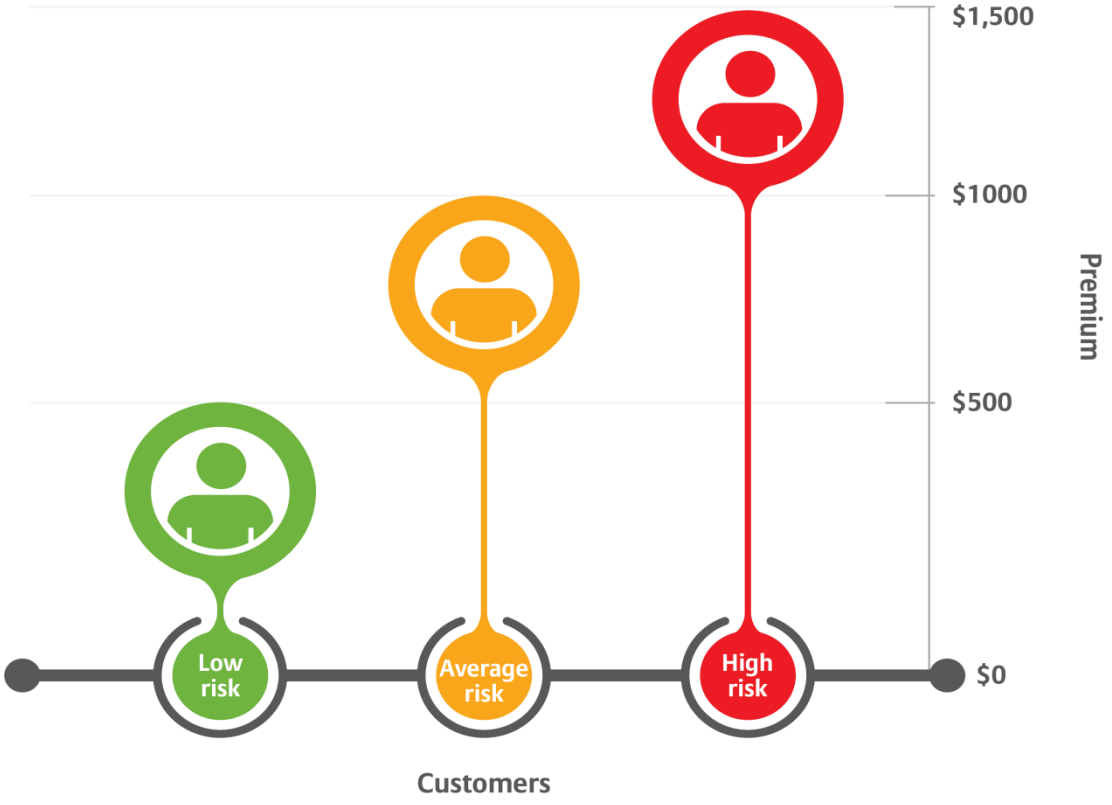
In an unregulated market, an insurer that sought to use the community rating approach would lose the lower risk customers that are being overcharged to other insurers who could offer a more competitive price and retain the higher risk customers that are being undercharged. The customers being undercharged would not contribute sufficient premiums to fund the claims payouts that would be made, potentially making the community rating insurer unprofitable.

Risk rating – different premiums for high and low risk policyholders

When premiums are 'risk rated', higher risk policyholders are charged a higher premium than lower risk policyholders. Principles of fairness and equity dictate that insurers should charge policyholders a premium that reflects, and is commensurate with, their risk. For example, why should older drivers pay a higher motor premium to subsidise the poor driving skill and behaviour of some young drivers?

Commercially, an insurer has no choice in the matter. If they don't set premiums according to risk, competitors that do will be able to offer the lower risk policyholders of a community rating insurer a cheaper, more competitive premium. This would leave that insurer with both fewer customers in total and, more significantly, a larger proportion of above-average, or higher, risk customers in its premium pool. That insurer is said to be suffering from 'anti-selection' or being 'selected against'. An insurer that suffers from anti-selection because it community rates is premiums (ie cross-subsidises between its high risk and low risk customers) will retain its less profitable (or loss making), higher risk customers and lose its more profitable, lower risk customers to its risk rating competitors. The combination of these effects will negatively impact a community rating insurer's profitability.

Figure 3: Risk rating – policyholders pay a premium that reflects their risk



Risk selection

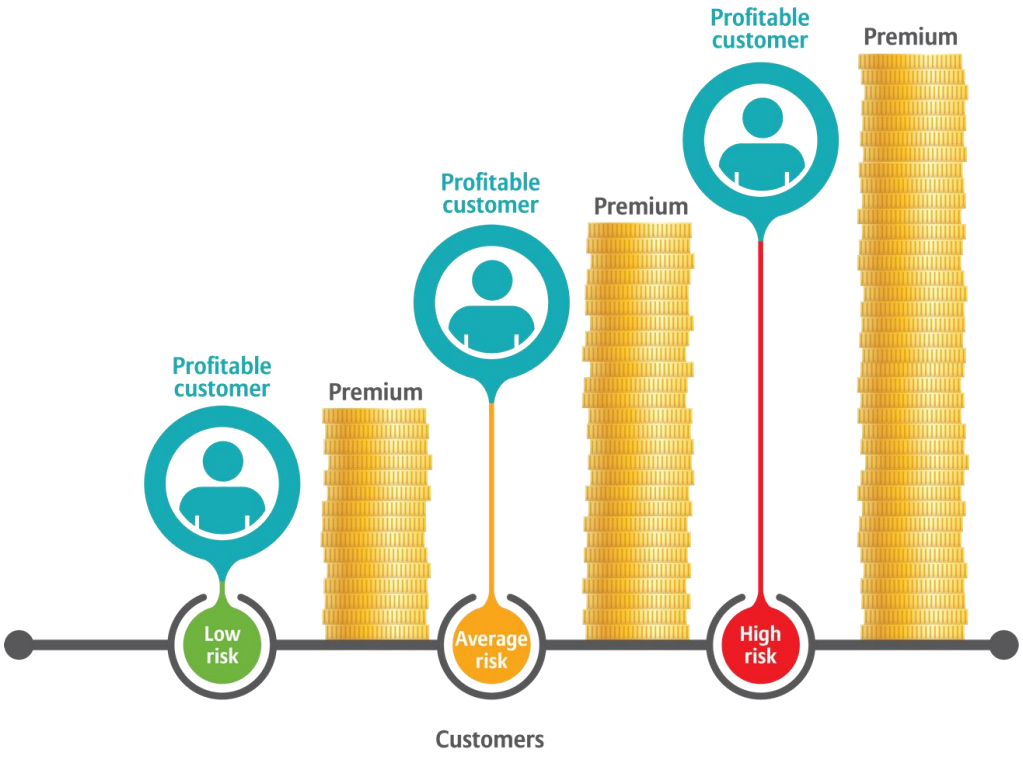
Are there good and bad risks?

At first principle, low risk customers are not necessarily 'good' (ie profitable) risks and high risk customers are not necessarily 'bad' (ie unprofitable) risks. Any customer can be a 'bad' insurance risk and they become so if the premium they are charged is insufficient to cover the amount of 'risk' they bring to the insurer's premium pool. Alternatively, any customer, not matter how risky, can be a 'good' risk if they are charged a premium that reflects their risk. Indeed, some insurers specialise in providing insurance to customers that have high risks. Allianz Australia, for example, has a business unit, Allianz High Risk Solutions, that does just that.

Charging the 'right' premium to match the risk

The real science, and art, in insurance, therefore, is to charge every customer the 'correct' premium to reflect their risk. If this was possible, all customers would be 'good' risks because they would all contribute a premium commensurate with the risk they bring to the premium pool and, hence, the claim payouts they will take out of it. In doing so, they fairly contribute to the running of the insurance company and to the return on capital the insurer's shareholders deserve.

Figure 4: Calculating the right premium to reflect the risk



Reality bites

Unfortunately, insurers do not live in quite such a perfect world because calculating the absolutely 'correct' premium for every policyholder is an extremely difficult, if not impossible, task. Further, to the extent that an insurer misprices any policyholder, and a competitor misprices them less, that insurer is at risk of being selected against. As a result, anti-selection still occurs even when all insurers in the market use a risk rating premium setting approach.

Uniquely, insurers are required to set the price of their product before they fully know their costs (eg of future claims). There are a range of uncertainties that create difficulties for insurers in calculating the correct premium. For instance, unforeseen events and adverse market conditions can adversely impact insurers' estimates of the future cost of claims. For example:

- the cost of imported car parts may rise due to an un-forecast fall in the value of the Australian dollar;
- a hail storm may damage tens of thousands of vehicles, totally overwhelming the supply capacity of the local smash repair industry and driving up repair costs;
- after a large-scale storm or cyclone event that causes damage to tens of thousands of houses, the cost of building services may rise as demand outstrips supply; and
- building regulations may change after an event (eg a bushfire) that increase the costs of rebuilding in the same bushfire prone location (as occurred after the 2009 Victorian Black Saturday bushfires).

To deal with uncertainty and protect themselves against the risk of anti-selection, insurers take a cautious approach to the pricing of risk. Another of the causes of this conservative approach to risk pricing is what economists refer to as 'asymmetric information'. That is, customers can sometimes know more about their risk profile than the insurer does, for example, information on their own risk behaviour (eg driving at excessive speed) or risk circumstances (eg flood risk). Insurers also suffer from 'imperfect' information. For example, poor quality and/or out-of-date government flood maps or a lack of data on how new vehicle safety technologies (eg anti-skid braking) will ultimately impact the frequency and severity of vehicle accidents and, hence, claims costs.

Figure 5: Estimating the right premium to reflect the risk

Selecting risks

To protect themselves against anti-selection, insurers use pricing and risk selection strategies to target 'good' (ie more likely to be profitable) risks in preference to 'poor' (ie less likely to be profitable) risks. Insurers also put in place strategies to ensure that they are not over represented in high risk areas and, as a consequence, accumulate an excessive market share of high risk customers (eg in cyclone, flood and bushfire zones, or high vehicle theft areas, or young drivers etc, etc). For example, if an insurer accumulates an excessive concentration of customers vulnerable to extreme natural events, its reinsurance costs are likely to rise relative to other insurers, causing its premiums to rise and making them less affordable and competitive compared to other insurers.

Box 1: Insurance pricing and comparison sites

Risk pricing in insurance differs from the way other goods and services are priced and is why a comparison site for insurance will not produce the same price and competition outcomes sometimes seen for other products. For example, an airline will generally offer a particular seat on a flight for the same price to anyone that puts their information into a certain air travel comparison site at a specific time prior to departure. A hotel will do the same for a room. An insurer, on the other hand, will not offer the same price to every customer. Indeed, an insurer may offer a different price to every customer, to reflect their individual risk profile.

Another difference is that the pricing of, for example, airline seats and hotel rooms, is influenced by 'marginal cost pricing'[6]. A seat on flight or room in a hotel can only be sold before the departure time or night of stay, respectively. For example, if a plane is still half empty or a hotel half full the day before the use date, airlines and hotels have an incentive to lower prices down towards the marginal cost of provision. In reality, the pricing of plane seats and hotel rooms is much more sophisticated and incentives also exist to offer lower prices well in advance of travel or the night of stay. Indeed, pricing can be very dynamic and move up and down in the lead up to the 'use by date' as providers seek to maximise returns in light of changes in demand and supply.

Insurance pricing, however, is very different. There is no concept of marginal cost pricing in insurance. The overall 'risk', or potential future claims liabilities, rises with each new policyholder in accordance with their individual risk profile and a commensurate premium needs to be collected. In addition, more policyholders increase an insurer's variable costs as more operational resources (eg claims and policy services staff) are required. The impact of both of these effects more than outweighs any small positive 'economies of scale'[7] impact an additional policyholder may have on an insurer's fixed costs. Thus, discounting, for the reasons applicable to other products commonly sold on comparison sites, will not occur for insurance. An insurer that discounts a customer's premium below the true price of the risk, has done nothing more than almost ensure that that customer will never be profitable. Further, that lack of profitability (or loss) will ultimately need to be offset by charging other policyholders a premium that exceeds the true price of their risk. In other words, the insurer has effectively imposed anti-selection on itself.

[6] In economics, marginal cost pricing is the practice of setting the price of a product at or slightly above its variable cost of production.
[7] Economies of scale refers to the reduction in the per unit costs associated with producing a good or service that occurs when a larger number of products or customers are spread over a business's 'fixed' costs (eg rent).

Setting the 'correct' premium

As suggested above, in an unregulated insurance market, no insurer will adopt a community rating pricing approach. All insurers will seek to risk rate all policyholders. Success then, depends on how accurately an insurer can do that. It is an insurer's premium setting ability, based on its risk pricing and risk selection capabilities, that will determine how well it can compete, whether it can generate adequate profits and, ultimately, whether it will survive.

Insurers invest heavily in expertise, information and technological capabilities to assess each customer's risk and try and calculate the 'correct' premium they should be charged. Insurers often refer to this as the 'technical' premium, which is a better description because, as discussed, uncertainties about future claims costs, imperfect information and information asymmetry, as well as technical limitations and other constraints, mean that it is in fact impossible to calculate the 'correct' premium for every customer. As a result, the premium setting and risk selection capabilities of home and motor insurers in the Australian market vary significantly.

Variations in insurers' prices

Even the premiums offered by insurers that have similar price setting capabilities can differ significantly. This arises because insurers will make different assumptions, for example, about the probability of a loss occurring and/or the cost of a resulting claim. Insurers will also sometimes use different rating factors, which will impact on their estimate of the 'correct' premium for a particular risk. For example, in cyclone areas an insurer might factor a house's roof material (eg, tiles, iron, Colorbond) into its premium calculations. Even if insurers use similar assumptions about which rating factors are relevant in pricing a particular risk, the weighting they place on their assumptions and rating factors when setting prices may differ. All these factors will lead to insurers offering different premiums for the same customer.

Such premium differences can be found in the prices on the home insurance comparison site established by the Australian Securities and Investments Commission (http://www.nqhomeinsurance.gov.au/). The ASIC comparison site shows 'indicative' premiums of insurers for home building and contents insurance policies in Nth Queensland. For example, for a home building policy in South Townsville (Postcode 4810) with a sum insured of $550,000, the 'medium' (ie average) premium among the represented insurers ranges from $3,030 to $7,011[8]. Across the full risk spectrum, that is, between the lower 10% and higher 10% of premiums, premiums ranged from $2,681 to $8,515).

[8] As at 9 February 2017.

Thus, due to variations between insurers' pricing capabilities and/or their assumptions about risk, different insurers will offer the same customer a different premium. In a competitive market, this is positive and will always occur. For example, because the 'technical' price of the risk will differ between insurers depending on business cost factors (eg operational costs, cost of capital, cost of reinsurance etc) but, relevantly, due to the risk price the insurer has calculated for a particular customer.

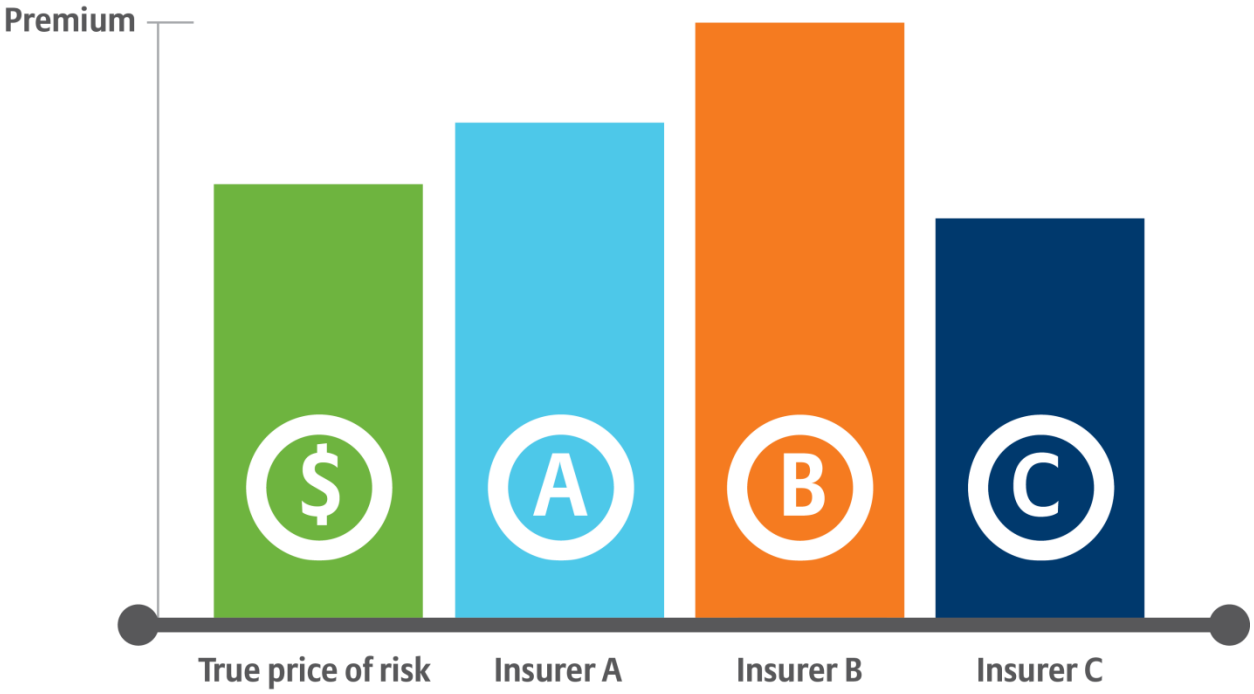
For example, a particular house located in Townsville insured for $550,000 has the same risk of being destroyed by a cyclone, regardless of which insurer covers it. The 'true' cost[9] of that risk will be the same for every insurer and be driven by the actual frequency and severity of loss[10]. Despite this, the factors driving the setting of premiums means that there is generally a range of prices offered in the market based on different insurers estimates of their own 'technical' price and which can diverge widely from the 'true' price of the risk.

Thus, while all insurers' technical premium will not be exactly the same for legitimate reasons (eg underlying cost structures), and no insurer's 'technical' premium is likely to be exactly correct relative to the 'true' price of the risk, some are more inaccurate than others. As a result, because of the inaccuracy inherent in insurance pricing, even in a market where all insurers are seeking to set premiums according to risk, anti-selection is alive and well. Just as importantly, even among insurers that have similar risk pricing capabilities, different judgements about risk assumptions, will result in very different prices in the market for the same risk (eg house or car). These price differences also create the risk of anti-selection.

[9] Where the 'true' price is the 'theoretical' one that an insurer would calculate if it had perfect information and no other restrictions on their ability to calculate the precise premium that exactly matched the value (ie the frequency and severity) associated with the risk.

[10] The frequency of loss relates to the probability of a claim being received and the severity of loss relates to the cost of that claim. A single property can have a number of frequency and severity probabilities for the same type of event. For example, an insurer might estimate that a particular house has a risk of a $150,000 claim in a 1 in 100-year flood, a risk of a $80,000 claim in a 1 in 50-year flood and a risk of a $30,000 claim in a 1 in 20-year flood.

Figure 6: Variations in market prices for a risk



Impact of different pricing capabilities and risk assumptions on anti-selection

An insurer can be selected against if it (inadvertently, unknowingly or otherwise) mis-prices a risk, for example, if it under-prices a risk and, as a result, attracts an unprofitable customers. However, due to differences in insurers' pricing and risk selection capabilities, some insurers will also be at risk of being selected against in relation to their lower risk customers.

The number of different premiums an insurer can put into the market depends on a range of factors such as:

- information from its past claims experience (eg the cost of repairing certain makes and models of motor vehicles);
- natural peril information (eg the risk of flooding at a particular address);
- 'rating factors' (eg the probability and damage severity of cyclones of different strengths);

- modelling capabilities (eg the size and number of its multi-variate generalised linear models[11]); and
- many others.

Insurers that lack some of the information needed to accurately price risk (eg a new insurer that has no past claims experience data) or lack some of the technological capabilities that underpin best-practise risk pricing, will have a more limited pricing capability than some or all of the other insurers it has to compete against.

Technological capabilities will also determine things like how frequently an insurer can change prices. For example, the proponents of a compulsory government comparison site for home and motor insurance have pointed to the one established for private health insurance in Australia. However, private health insurance premiums (or, at least, premium increases) are approved by the Minister for Health annually and, all things equal, are set for the following 12 months. Some general insurers have, or are developing, the capability to change motor insurance premiums for some (or all) customers numerous times per day.

When customer information (eg age, gender, address, make and model of car, claims and demerit point experience etc) is added, insurers' pricing 'engines' may be able to produce many more combinations of premiums than there are customers in the market. For example, Allianz is capable of producing over 22 Trillion different motor insurance premiums for the Australian market and many times this number of different home insurance premiums[12].

Figure 7: Allianz's pricing capability – up to 2.95E+101 possible Australian home insurance premiums

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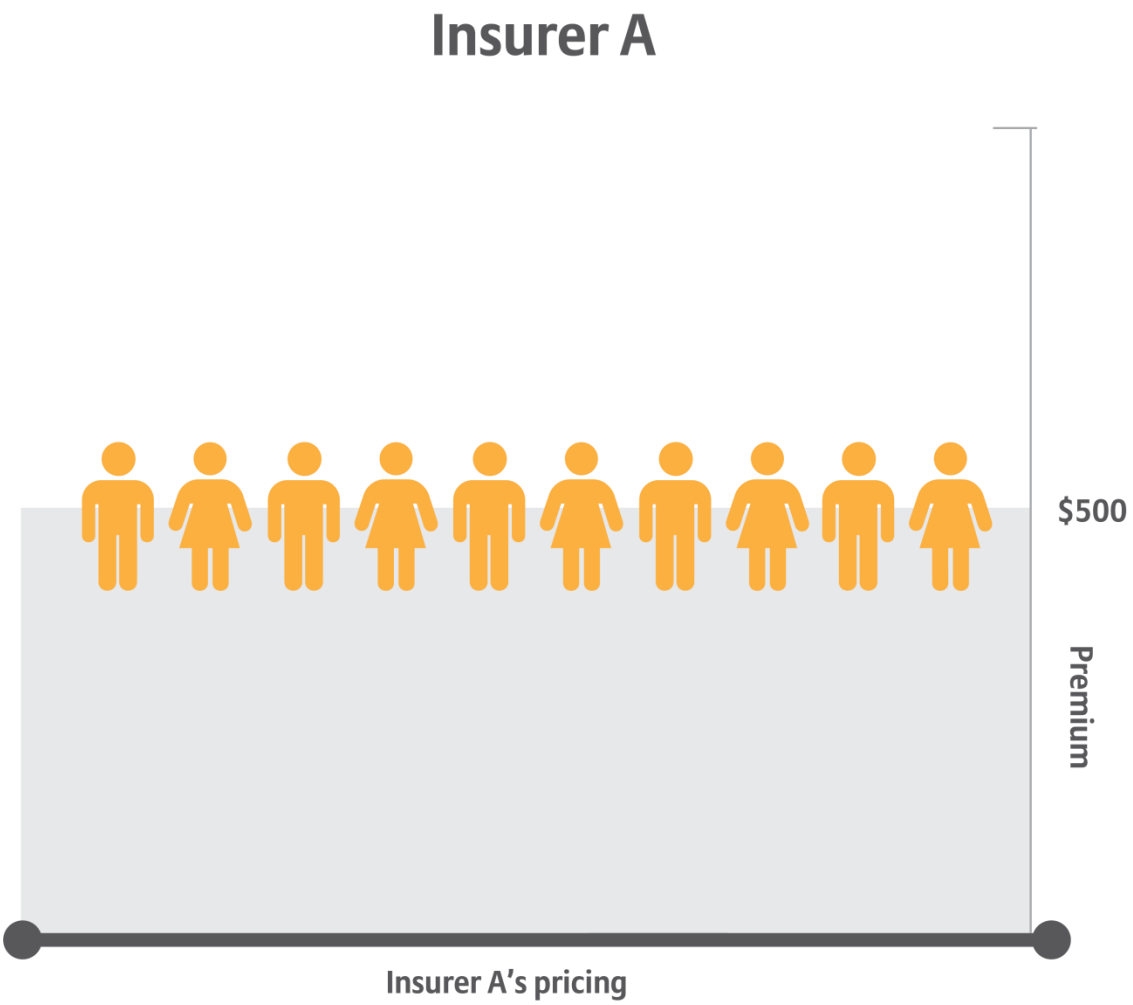
[11] Multi-variate generalised linear models are statistical models used by insurers for a variety of purposes, including pricing.
[12] Around 2.95E+101.

For example, Insurer A might be able differentiate 100,000 prices for motor insurance based on a range of rating factors such as type of vehicle, age of driver, postcode where the car is garaged, etc. These 100,000 prices will, all things equal, range from low to high, depending on the level of 'risk' associated with each customer group. Assuming, hypothetically, that there are 10 million car owners whose risk profiles are spread evenly across those premiums, Insurer A would be able to provide a different premium to 100,000 groups of 100 customers.

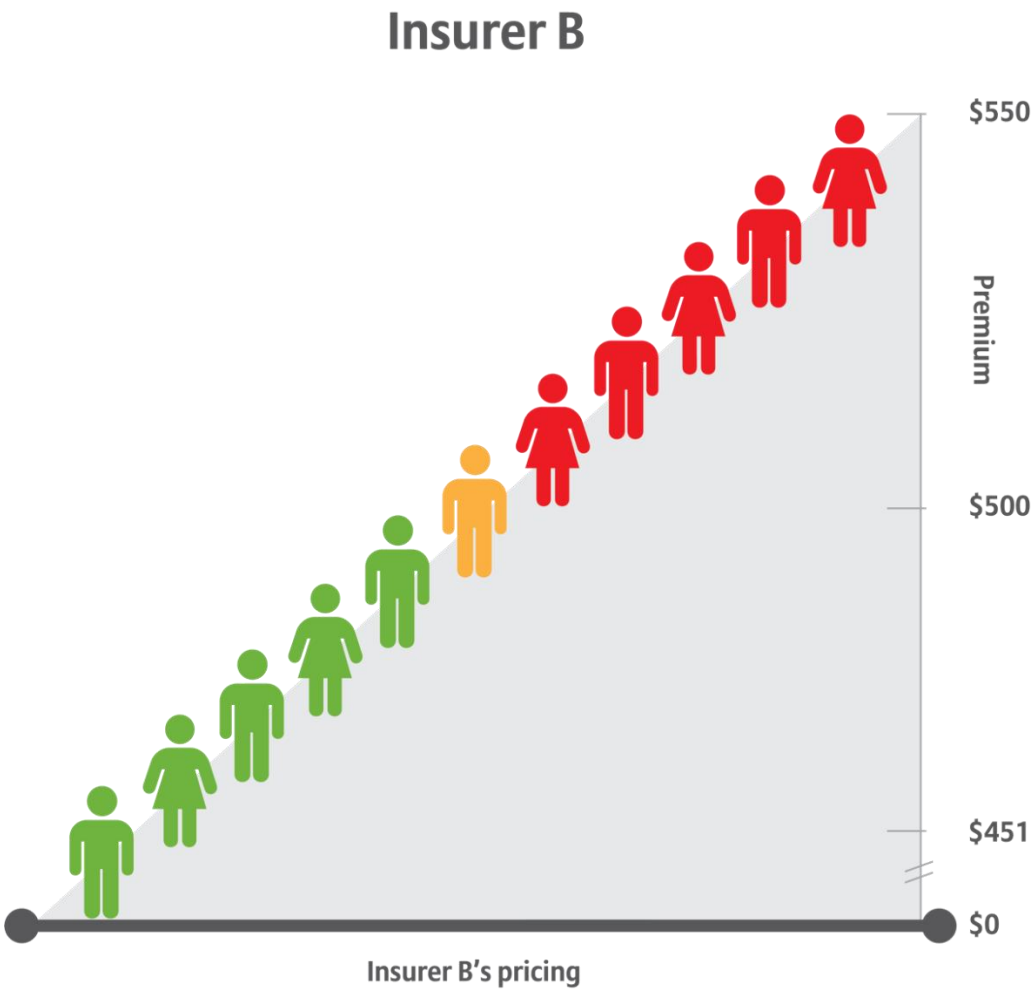
Figure 8: Insurer A's premiums for a group of car insurance policyholders



A competitor, Insurer B, on the other hand, might have the capability to differentiate 10 million motor insurance prices by applying a more sophisticated pricing capability, that is, 100 times more than Insurer A. As a result, for Insurer A's lowest risk customer group which, for example, it is charging $500, Insurer B will be able to offer 100

individual prices, for example, ranging from $451 to $550. In other words, for a group of 100 customers that Insurer A sees as having the same risk profile (and hence should be charged the same premium), Insurer B is able to divide that customer group into a further 100 risk profiles, from low to high.

Figure 9: Insurer B's premiums for the same group of policyholders



Insurer B's better pricing capability has revealed that Insurer A has over-estimated the risk of, and is charging too much to, 50 of those customers. Also, that Insurer A has under-estimated the risk of, and is not charging enough to, the other 50. Insurer B can offer a cheaper premium of less than $500 to the 50 better risks in the group and attract them away from Insurer A. On the other hand, the 50 poorer risks, will choose Insurer A because, being under-priced relative to the true price of the risk, its $500 premium is cheaper than Insurer B's (which range from $501 to $550 for those customers).

Figure 10: Comparison of Insurer A's premiums and Insurer B's premiums for the same customers

As a result of its mis-pricing of risk, Insurer A loses its better risk customers, which would have been profitable because its premium of $500 is higher than the true cost of the risk. On the other hand, Insurer A retains or attracts higher risk customers because its premium of $500 is below that being charged by competitors that have better price setting capabilities.

The above discussion focuses on the consequences of mis-pricing risk due to the differences between insurers' pricing capabilities. However, negative commercial consequences can also occur even if insurers have similar pricing capabilities. As discussed above, prices in the market can also differ widely due to the different

assumptions insurers knowingly make about risk. Thus, even if all insurers have best-practise pricing capabilities, some will price the same risk higher or lower than others.

Experience with insurance comparison sites shows that it biases consumer purchasing behaviour towards an unhealthy focus on price over the qualitative features of insurance products. Customers faced with a range of prices for insurance cover offered by a number of well known, established and trusted brands, tend to gravitate to the lowest price. Even if the lowest priced insurer has best practice pricing capability and does not believe it has mis-priced the risk, it then suffers a different type of insurance risk. That is, accumulation risk, or the risk of accumulating an excessive share of customers with a particular risk profile, which may exceed the insurer's risk appetite for customers with that risk profile.

Risk accumulation runs counter to the principle of spreading risk introduced earlier in the submission. It was also noted earlier that it is against an insurer's interest to have an excessive market share among any customer type with high risk characteristics (eg young drivers, or flood, cyclone or bushfire prone houses). As discussed, risk accumulation can have a negative impact on the cost of reinsurance, which will drive up an insurer's cost base and make it less competitive.

Impact of anti-selection on competition

Figure 10 shows how Insurer A is selected against by Insurer B. Due to its more limited pricing capability, Insurer A is unknowingly charging insufficient premium for its share of those 100 customers and, as a result, will suffer a lower level of profitability than Insurer B.

Insurer A's disproportionate share of higher risk customers will result in an increase in its claims frequency (ie claims per 100 policyholders) and/or its average cost of claims. As a result of the overall increase in claims costs that Insurer A will experience, the total amount of premium it will need to collect from the remaining policyholders in its premium pool will have to increase in order for it to remain profitable.

An insurer that suffers from such anti selection is therefore forced to raise its premiums. However, this creates opportunities for competitors like Insurer B with better pricing capabilities to further 'cherry pick' the better risks out of Insurer A's premium pool. Thus, the process of anti-selection creates a vicious cycle that will see Insurer A's premiums rise further, making them increasingly uncompetitive, and its profitability further decline to the point where it has no choice but to exit the market.

The market environment described above would also create a significant barrier to entry for new insurers seeking to enter the market. Put simply, a prospective insurer would

know that unless it can match the pricing capability of the best in the market, it will face an extremely challenging competitive environment with a high risk of suffering anti-selection.

New entrants can never replicate all the risk selection capabilities of long-standing insurers in the market, for example, the advantage they derive from historical claims experience information. On its own, however, this advantage has not prevented new insurers entering into the Australian home and, particularly, motor insurance markets over the last decade or more, some of which have been quite successful. This reflects the highly competitive market environment that exists for home and motor insurance in Australia. However, the success of some of these new entrants has specifically relied upon not disclosing their pricing to other insurers (eg by not allowing online quotes). Such a strategy would be totally annihilated by a mandatory price comparison site.

Moreover, given the inevitable focus on price created by comparison sites, consumers' familiarity with and trust of well-established brands means that a new entrant would need to price materially lower than the established competitors to attract consumers. Given a new competitors' likely more limited pricing capability, such a pricing strategy would only place them at greater risk of anti-selection and failure. As a consequence, a mandatory comparison site would also create barriers to entry into the relevant insurance markets and therefore stifle competition.

Conclusions: Impact of comparison sites on prices and competition

Comparison sites have the ability to quickly uncover inaccurate pricing and negatively impact insurers accordingly by accelerating and exacerbating the impact of anti-selection and risk accumulation on insurers. Such adverse financial impact is delivered particularly quickly in motor insurance because car accidents happen every day, compared to home insurance, where the true extent of mis-pricing may only be really (and severely) felt after an extreme weather event.

Impact on prices for higher risk customers

In light of the desire to spread risk and avoid risk accumulation, the limitations on risk pricing and the risks of anti-selection, what strategies would an insurer adopt if it was forced to participate on a mandatory price comparison site?

For customers that are regarded as having a high risk profile, an insurer would be extremely concerned if it discovered that it was the lowest price in the market. For example, if an insurer was offering the cheapest home insurance in Nth Queensland it would potentially attract significant numbers of customers away from other insurers and

risk accumulating an excessive exposure to cyclone risk. In such a circumstance, there can be two explanations as to why that insurer is cheaper than its competitors:

- first, because its pricing capability is superior to all other insurers, its price is the 'correct' one and all its competitors are unknowingly setting a wrong, higher price; or
- second, its pricing is wrong and all the other insurers' prices are closer to the 'true' risk price because they have superior pricing capabilities.

If an insurer came to the first conclusion, its cautious instincts would likely prevail and it would increase its price to protect itself against the risk of anti-selection. Even if did not believe it had mis-priced the risk, the risk of accumulating an excessive share of customers with a higher than average risk profile would lead it to the same conclusion, that is, to increase premiums.

If an insurer came to the second conclusion, it would immediately increase its price, again, to protect itself against anti-selection and risk accumulation. Thus, comparison sites pose a real risk of increasing the price of insurance for people that have high risk profiles. And there are a myriad of such customer groups, related for example to exposure to natural perils, but also other locational factors (eg areas of high home burglary or car theft risk) or things like age of vehicle driver.

In the real world of course, most insurers will not have employees sitting around manually obtaining quotations off the comparison site. This would be difficult given the thousands of different risk scenarios for home and motor insurance across a country as diverse as Australia, the premiums for which will constantly change as insurers change prices for all manner of commercial and technical reasons.

Insurers, to the extent of their capability, will set up sophisticated IT systems to interact with the comparison site and automatically and continually run thousands of quotations per hour[13] in order to unearth and flag mispricing. That is, where they face potential anti-selection or accumulation risks, or where 'cherry picking' opportunities exist.

This is what insurers operating on comparison sites in the UK and other countries do. For some insurers, these systems may be linked with their pricing systems, which will allow new, sufficiently higher, prices to be calculated and immediately posted on the comparison site. Even if the comparison site sought to technically prevent insurers from automatically running quotes on the site, insurers would invest in manual alternatives – the risks and opportunities are too great no to.

[13] Using what are referred to as 'bots' in IT jargon.

Impact on insurer profitability, market consolidation and competition

Insurers with less than best practise pricing capabilities will suffer anti-selection unless or until they discover that it is occurring and rectify the situation. The impacted insurers will lose their better risks and accumulate poor risks at premiums that are unlikely to provide an adequate profit. To the extent that this continues, such insurers are unlikely to earn enough profit to make sufficient return on capital to satisfy their shareholders.

Overtime, such an outcome is likely to lead to industry consolidation and, consequently, less competition in the market for that particular class of insurance. Even insurers with best practice pricing capabilities are in the end only estimating the true price of the risk. Insurers therefore rely on creating an overall pool in which more profitable risks balance out less profitable (or loss making) ones. However, in an environment where most customers purchase only on price, all insurers will tend to lose a larger proportion of their profitable customers and retain a larger proportion of the unprofitable ones.

Price discounting of good risks may well occur, but when everyone does it, it does not prevent anti-selection or concentration risk. Further, given that, all things equal, the cost of claims at the industry level remains unchanged, if the premiums for good risks are discounted below insurers' target profit margins, insurers can only retain profitability by (further) increasing the premiums charged to higher risk customers.

In other words, the existence of a comparison site cannot, all things equal, impact the overall cost of claims at the industry level. Thus, if the comparison site increases competition for the lower risk customers through excessive price discounting, an adequate industry premium pool can only be maintained if there are offsetting premium increases for the higher risk customers. And this effect is over and above the premium increases for higher risk customers that will occur at the individual insurer level as a result of insurers seeking to avoid anti-selection and concentration risk.

Comparison sites exacerbate and accelerate the ability of consumers (and other insurers) to identify those insurers that are mispricing their cover. Of course, consumers are not aware they are doing this, they are simply responding to the lowest price in the market. However, if international experience is any guide, the proponents of comparison sites are unwittingly promoting a competitive market dynamic that will result in higher prices for many consumers with high risk profiles and unsustainably low levels of profitability for some insurers. The latter will ultimately lead to less insurers in the market and, to the extent that that is a measure of competition, a less competitive market.

This has been the experience in the German market, where the number of motor insurance policies sold through comparison sites (also called 'aggregators') has grown

significantly in recent years. A recent pwc report[14] on the German experience with insurance comparison sites found that:

> *"..for a number of years already [2008-2014], aggregators have been by far the fastest-growing sales channel in the German motor-related insurance business." (p14);*
>
> *"In the past five years [2008 0 2013] alone, the accumulated underwriting loss [for motor insurers] amounted to 4.7 billion euros."(p10); and*
>
> *"[The impact of] Aggregators/Portals [has been],*
>
> - *Continuous price wars[15]*
> - *Market consolidation" (p13)*

For the reasons set out in our submission (and many others not covered in this submission but included in that of the Insurance Council of Australia and other insurers), Allianz does not support the mandated participation of insurers in comparison sites, whether they be commercial, non-profit or government run ones. Allianz has had the experience of participating in commercial comparison sites for motor insurance in other countries, such as the UK. The UK experience was wholly unsatisfactory. The inevitable focus by consumers on price over the suitability of insurance cover saw the quality of insurance products and customer service levels fall as insurers sought to cut costs. Even despite this, participation became unprofitable and, as a result, Allianz withdrew from retail comparison sites in the UK.

Had participation been mandated, Allianz's only option to cease writing unprofitable business would have been to withdraw from offering motor insurance in the UK market altogether. Thus, in addition to the risk of an insurer becoming totally unprofitable and ceasing to exist, a mandatory national comparison site also risks reducing the number of insurers offering the types of insurance included on the site. While an insurer making losses can always raise its prices above those of its competitors to seek to return to profitability, their lack of competitiveness with result in falling sales, further anti-selection and lower economies of scale. These impacts will require even further premium increases to cover costs and the insurer will become so uncompetitive it makes no commercial sense to continue offering the product anyway. Again, a reduction in competition in the market would follow.

[14] Pwc, *The Insurance Monitor: To be or not to be – the future of motor insurance*, Issue 3, January 2015,
[15] But likely only for customers that are perceived to have a good risk profile.