FINANCIAL CONDUCT AUTHORITY

# General insurance pricing practices

## Interim Report

**Market Study**

MS18/1.2

October 2019

# How to respond

We are asking for comments on this report by 15 November 2019

**You can send them to:**
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# Contents

# 1 Executive summary

## Overview

**1.1** General insurance products are important for consumers and provide them with protection when things go wrong, for example if they have a car accident or their house is damaged. Over 45 million home and motor insurance policies were written in 2018. The retail general insurance sector is key to the UK economy, generating £24 billion of revenue in 2017. Home and motor insurance generated £18 billion in gross premiums in 2018. It is important that the general insurance sector works well and delivers good outcomes for consumers.

**1.2** We launched this market study to understand whether pricing practices in home and motor insurance support effective competition and lead to good consumer outcomes. This followed a thematic review showing that consumers who stayed with the same provider for a long time paid on average significantly more for home insurance than newer consumers. We were concerned about the potential harm this could cause to consumers.

**1.3** The general insurance sector has been an area of focus for us over recent years. For example, we have introduced new rules in relation to the Insurance Distribution Directive and to increase transparency and engagement at insurance renewal. We have also looked at value in the general insurance distribution chain and value measures regarding the quality of general insurance products.

**1.4** Stakeholders have also raised concerns about outcomes from general insurance pricing practices. In September 2018, Citizens Advice made a super-complaint about loyalty pricing to the Competition and Markets Authority (CMA). Home insurance was one of five markets included in the super-complaint. The CMA published its response in December 2018. It recommended the FCA look at ways to tackle price walking and other harmful business practices in home insurance.

**1.5** We found that these markets are not working well for consumers. Firms use complex pricing practices that allow them to raise prices for consumers that renew with them year on year. This is called price walking and the fact firms do this is not made clear to consumers. When we asked for consumers' views on price walking we found that, whether they shop around or remain with their provider, they think price walking is wrong.

> It [price walking] is not fair, it makes me feel cheated.
>
> Market study consumer research: Comment from in-depth interview with an individual consumer who regularly shops around

**1.6** Our other key findings are:

- 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.

- We estimated the cost of attracting new business is £2.3bn per year and will be borne by all consumers through higher prices.
- 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.
- 1 in 3 consumers in our consumer research who paid high prices showed at least one characteristic of vulnerability, such as having low financial resilience or capability. For consumers who bought combined contents and building insurance, lower income consumers (below £30,000) pay higher margins than those with higher incomes.
- 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.
- Firms earn profits primarily from activities other than underwriting, such as add-ons, premium finance, fees and charges or investment income.
- Many consumers who switch or negotiate their premium can get a good deal.

**1.7** Our statutory objectives are to make relevant markets work well by protecting consumers, promoting competition and protecting and enhancing the integrity of the UK financial system. These objectives form the basis of this market study's aims. Linked to these objectives, our goal is to ensure that in general insurance markets:

- Consumers can trust firms to deliver fair value and treatment for all consumers.
- Firms put fair value and treatment of customers at the centre of their pricing practices.
- Firms do not engage in practices that make it difficult for consumers to make informed decisions and act to get better deals.
- Consumers who do not switch are not unreasonably penalised.

**1.8** It is important that customers purchase good value general insurance products. Value is driven not only by price but also by the quality of the product. Consumers should be able to trust that firms will provide them with a quality product that delivers on reasonable expectations of performance.

**1.9** Industry has acknowledged the need to tackle concerns about pricing practices and has been taking some steps to do this. However, we think that FCA intervention is also likely to be required. In the immediate term, we will continue work to address the problems we have uncovered including to:

- ensure firms improve the governance, control and oversight of pricing practices.
- deliver the changes required from firms following implementation of the Insurance Distribution Directive.
- continue improving transparency and engagement at insurance renewal. We introduced rules to do this in 2017, and publish our evaluation of the impact of these alongside this report. We estimate consumer savings of £185 million per year due to this intervention.

**1.10** We are also considering a range of industry wide measures to reform these markets so they work well for consumers in the future.

## How firms set prices for home and motor insurance

**1.11** Broadly, the price for home and motor insurance is made of 3 elements. These elements amount to the overall retail price paid by the customer (excluding insurance premium tax). Figure 1 below summarises this:

***Figure 1: Summary of how most firms in our sample set prices***

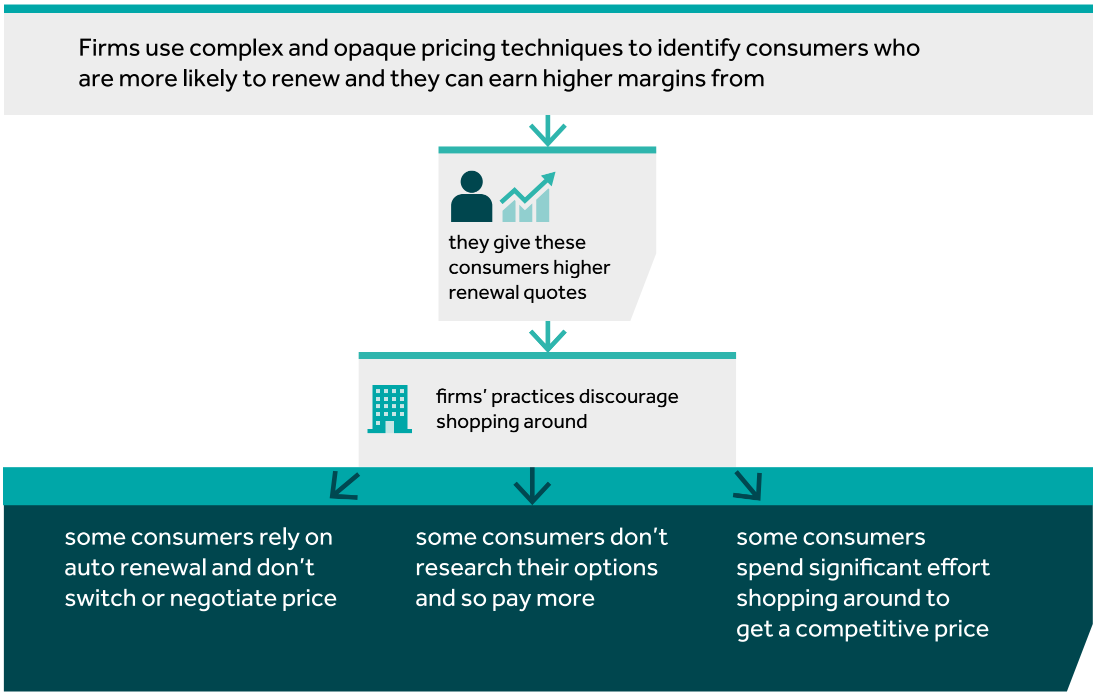

Source: FCA analysis of information gathered from firms during the market study

**1.12** Our thematic review on home insurance pricing practices identified differentials in the margins firms earned between consumers of equivalent risk and cost to serve. So this market study has focused on how firms set margins for customers and not how firms assess individual consumers' risks (underwriting). The degree of capability and sophistication, coupled with the nature of the firm's strategy in optimising the margin across all business varied. However, only one firm in our sample applied a uniform margin to all its business.

## What we are concerned about

**1.13** Overall, our analysis raises significant concerns that these markets could work better and are not delivering good outcomes for all consumers. Our concerns about how this leads to harm is in Figure 2 below:

***Figure 2: Analysis of how pricing practices may lead to harm***




Source: FCA analysis

## Action we are considering

**1.14** We summarise the potential remedies that could tackle our concerns below, and discuss them and those that we propose not to consider further in more detail in Chapter 7. We will continue our work to tackle immediate harm from pricing practices alongside longer-term changes to make these markets work better in future.

**1.15** We will look carefully at which remedies can achieve this in the most effective and proportionate way. Some of the remedies we are considering could be more interventionist. We will keep these under review. We will consider if there is a case to remove them should they successfully tackle harm and the market has developed sufficiently so that they are no longer required.

**1.16** We will look closely at how firms could change their business models in response to potential remedies, for example reducing the quality of core insurance products or increasing the sale of add-ons to consumers that may offer little additional value. These types of practices would also result in poor outcomes for consumers and we would not expect to see firms use them.

**1.17** We will consider the potential impacts of remedies on the outcomes for different groups of consumers. Many consumers can get lower prices if they actively shop around and switch. We do not want to remove these benefits for these consumers.

1.18 We will use our research on international comparisons of general insurance markets in other countries to provide insights into potential remedies to address concerns we have identified in this market study.

## Our remedies will fit with wider regulatory efforts to improve consumer outcomes

1.19 We will use the full range of our tools to take a holistic approach to tackling our concerns. Any remedies that may emerge from this market study will fit with our ongoing work in general insurance markets.

1.20 Good governance over pricing outcomes for consumers should be central to firms' pricing practices. In October 2018, our Dear CEO letter to firms about retail general insurance pricing practices set out our expectations, including on governance, control and oversight. We have reviewed firms' responses to this letter, and there is a wide variation in the nature, extent and quality of firms' oversight of pricing practices. We have seen some examples of improved practice by some firms. However, this remains an area that requires significant improvement.

1.21 We implemented the Insurance Distribution Directive (IDD) in the UK on 1 October 2018. This introduced new conduct of business requirements for insurers and distributors. These rules include new requirements on firms to act honestly, fairly and professionally in the best interests of consumers, and new requirements for product approval and oversight. Our rules also require firms to provide customers with appropriate information so they can make informed decisions about taking out a contract.

## Remedies to tackle high prices for consumers who do not switch or negotiate

1.22 We are concerned about the harm to customers who do not switch or negotiate and are paying higher prices than customers of equivalent risk and cost to serve.

1.23 We recognise that how prices are set for home and motor insurance is complex. Any intervention that changes price setting could impact the way the industry is structured and how competition works. We are considering supply-side remedies despite these complexities.

1.24 The options we are considering include:

- Limiting pricing practices that allow firms to charge higher prices to consumers who do not switch, for example, restricting or banning margin optimisation based on consumers' likelihood of renewing.
- Automatic switching of consumers paying high prices to lower priced products that provide equivalent cover.
- 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 our existing product governance requirements.
- Requirements for firms to provide data tracking their actions to improve pricing practices and monitoring pricing differentials between their customers.

## Remedies to address practices that could discourage switching

1.25 In addition to continuing our work in the immediate term to address problems we have uncovered, we are considering action to address practices by firms that discourage switching or do not support effective competition. In doing so, we will take account of the CMA's principles for healthy competition and acceptable behaviour by firms. These were set out in the CMA's update on its response to the loyalty penalty super-complaint.

1.26 Potential remedies to these practices could include:

- 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.

1.27 In developing any potential remedy, we will carefully consider the impact on the potential advantages of auto-renewing insurance.

## Remedies to make firms be clearer and more transparent in their dealings with consumers

1.28 Complexity and lack of transparency around how firms set prices is unlikely to help consumers make informed decisions.

1.29 We see firms being clear and transparent in their dealings with all consumers as key to well-functioning markets. Firms are already required under our rules to communicate with consumers in a way that is clear, fair and not misleading. They are also required to disclose last year's premium at each renewal, so that it can be easily compared to the new premium offered. To further improve transparency and aid consumer engagement, we are considering:

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

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

1.30 We will also look at ways that 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, price comparison websites (PCWs) help consumers shop around and compare prices. However, consumers need to actively provide their data to benefit fully from these services. We are considering further work on uses of data and analytics across sectors and will communicate more details in due course.

**1.31** We believe 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. We recognise it could take some time for the potential of Open Finance to be fully realised, and will depend on consumers engaging with it. But we want general insurance markets to be part of these transformations to ensure they work well for the future. We will take this forward as part of our advisory group on Open Finance. This group will inform our Call for Input on our strategy towards Open Finance which we will publish later this year.

## Next steps

**1.32** We would welcome stakeholder feedback on the following questions:

**Q1:** **Do you have views on the interim findings set out in this report?**

**Q2:** **Do you have views on the potential remedies we propose to focus on? What are the potential benefits, challenges and unintended consequences that may arise from these?**

**Q3:** **Do you have views on the potential remedies that we propose not to focus on? What are the potential benefits, challenges and unintended consequences that may arise from these?**

**Q4:** **Do you think there are other remedies that we should be considering? If so, what remedies and how do you think they would address the harm we have identified?**

**Q5:** **Are you aware of potential changes or innovations in the home and motor insurance markets that may address the harm we have identified? If so, what are these and how will they address the harm and are there any potential unintended consequences?**

**1.33** Please send views on the above questions to GIPricingPractices@fca.org.uk by 15 November 2019. We will take these views into account in our final market study report. We will also be engaging directly with stakeholders to discuss this interim report shortly. We are grateful to firms and other stakeholders who have provided information that has informed this interim report.

**1.34** We plan to conduct further analysis, including of potential remedies and their associated costs and benefits before we publish our final market study report. We aim to publish our final market study report, alongside a consultation paper on any proposed remedies, in Q1 2020.

# 2 Our approach to this market study

## Our approach to this market study

2.1 The scope of the market study is home and personal motor insurance. We have focused on understanding how competition works in these markets by looking at:

- The structure of the general insurance sector. This includes the providers of home and motor insurance, their roles in supplying these products and associated add-on products and premium financing, and the different business models.
- How firms set prices and treat their customers in this process.
- Whether pricing practices support effective competition in delivering good consumer outcomes.
- Outcomes from pricing practices, including the scale of any price differentials between consumers and who is paying higher and lower prices, including whether they may be vulnerable.

2.2 We have used our analysis of these areas to inform whether pricing practices raise concerns and whether we should take any action. In assessing this, we have used the framework set out in our Approach to Competition. We have used what the evidence tells us as part of our framework for assessing concerns about price discrimination.

## Scope of the study

2.3 Our market study builds on our thematic review of home insurance. It focuses on pricing practices for home and motor insurance. It does not include other general insurance products such as health, pet and travel insurance. However, where possible, we will identify lessons from this market study that are relevant to other markets that we regulate.

2.4 Different parties are involved in supplying general insurance. This includes those who provide or sell insurance directly to consumers, and third parties such as brokers and digital comparison tools, including PCWs. Not all of them set the price consumers pay for insurance, but they do influence the dynamics of competition and pricing outcomes for consumers. The scope of this market study includes all of the parties described in this paragraph.

## Issues the market study has looked at

2.5 Our assessment of whether markets work well for home and motor insurance customers looked in particular at three key broad areas, set out below.

## How firms set prices and treat their customers

2.6 We have assessed how firms treat consumers in pricing home and motor insurance, and the impact this has on competition and consumer outcomes. We looked at:

- pricing models and strategies adopted by firms and whether these lead them to take advantage of certain consumers.
- whether firms provide consumers with clear and accurate information when they renew insurance.
- the impact of contractual terms, such as auto-renewal.
- how firms address their responsibilities to treat customers, including vulnerable consumers, fairly.

2.7 We also examined consumers' perspectives and attitudes to their experience and the fairness of pricing outcomes in the motor and home insurance markets.

## Whether pricing practices support effective competition

2.8 We also sought to understand the impact of pricing practices on competition in the home and motor insurance markets. We analysed whether pricing practices support effective competition that delivers good outcomes for consumers. In doing this, we have been guided by the FCA's Approach to Competition. We have examined whether these practices:

- lead to price discrimination that intensifies or dampens competition.
- work in the interest of only some or all consumers.
- raise the cost of providing insurance either through generating excessive search and switching costs for consumers or increasing customer acquisition costs for firms (or both).
- lead to firms making high profits.
- increase or restrict consumers' access to insurance.
- create barriers to existing and new firms developing innovative business models and different pricing strategies.

2.9 We also examined consumers' understanding of general insurance pricing practices, and their shopping around and switching behaviour, to help us understand its impact on competition.

## Consumer outcomes

2.10 We wanted to get a deeper understanding of firms' pricing practices by assessing how firms set prices and how competition works in each market. We looked in detail at consumer outcomes from pricing practices, including the proportion of consumers that may pay very high prices and who they are. We have looked at:

- the differences between prices paid for each of motor and home insurance by different consumers compared to the cost of providing them with insurance.
- how many consumers in each market are affected by paying higher prices.
- the characteristics of consumers paying higher prices, especially the extent to which they may be vulnerable.
- why some consumers end up paying higher prices.

## Evidence we gathered to support out analysis

2.11 Our interim findings are drawn from multiple pieces of analysis including:

- Analysis of data gathered from insurers, intermediaries and PCWs on:
  - Information on firms' business structures, pricing models and strategies.
  - Policy level data over a 5-year period (from 2014 to 2018) from 24 price-setting insurance and intermediary entities identified by their firm reference number (FRN). The sample covers 17 insurers for home insurance and 18 for motor insurance. The data include general information on the insurance policy (for example inception and duration, characteristics, sales channel), price and cost information (of core policy, addons), ancillary fees and information on the policyholder. The dataset contains nearly 7 million observations for over 2 million unique policies for home insurance and 10 million observations for nearly 4 million unique policies for motor insurance. The market share of the insurers based on Gross Written Premium (GWP) in our sample represent 76% and 91% of the motor and home underwriting market respectively. We selected the intermediaries to be representative of the different types of business models in the markets. In terms of market share of the intermediated market, the intermediaries in our sample represent 23% of home insurance and 69% of motor insurance.
  - Financial information and management accounts. We analysed this to understand the range of business models which firms use across the supply chain for home and motor insurance, how firms generate revenue and their profitability. We collected annual financial data over a 6-year period (2013 to 2018) from 17 insurers, 12 intermediaries (which includes both price setting and non-price setting intermediaries) and 4 PCWs.
  - Information about firms' policies and strategies for ensuring they treat customers fairly, the communications they provide to customers at renewal and the contractual terms used.
  - Responses from firms to a range of other important questions. These included how firms compete for new and existing consumers, potential barriers to entry and expansion, and recent and future market developments. We used responses from 17 insurers and 12 intermediary firms for this analysis.
- Consumer research that combined (across 18 insurance companies):
  - Online surveys of over 3,500 and 6,800 home and motor insurance customers.
  - Computer Assisted Telephone Interviewing of over 600 customers each for both home and motor insurance.
  - 10 in-depth phone and face-to-face interviews to explore in more detail consumers' experiences, behaviours and perceptions.
- Combined analysis covering a matched sample of consumers from the customer transaction data and those who responded to our consumer research. This analysis looked in more depth at the characteristics of these consumers and the outcomes they get from pricing practices.
- Research looking at pricing practices for general insurance in other countries. We analysed the similarities and differences between how these markets operated compared to the UK, and the resulting consumer outcomes. This was primarily to inform our consideration of potential remedies.

- We commissioned research by Deloitte looking at future developments in general insurance pricing. The scope of the work was to look at:
  - what new business models are developing in the motor and home insurance markets.
  - the likely key changes over the next few years that will impact on general insurance pricing practices.
  - how market developments might impact the types of remedies that might be most effective in addressing potential harm from pricing practices.

**2.12** We also drew on other FCA work to inform our analysis, particularly the previous thematic review on pricing practices for home insurance, our review of firms' responses to our Dear CEO letter on pricing practices for general insurance, and our evaluation of rules to increase transparency and engagement at insurance renewal.

## Structure of this report

**2.13** The rest of this report is structured as follows:

- Chapter 3 sets out the market overview and our analysis of:
  - The structure of the general insurance sector, and the home and motor insurance markets. This includes the different firms in the supply chain and their business model and distribution channels for home and motor insurance.
  - The current market environment.
  - Future market trends and innovation.
- Chapter 4 sets out our analysis of how firms set prices for home and motor insurance and how they treat customers.
- Chapter 5 sets out our analysis of whether pricing practices support effective competition.
- Chapter 6 sets out our findings on consumer outcomes from pricing practices.
- Chapter 7 discusses the potential remedies we are considering to address harm we have identified.

**2.14** We have also published a number of annexes to this report:

- Annex 1: Consumer outcomes technical annex
- Annex 2: Business models and financial analysis technical annex
- Annex 3: International comparisons
- Annex 4: Consumer research report
- Annex 5: Consumer research technical report
- Annex 6: Future trends in general insurance pricing research report

# 3 Market overview

## The general insurance sector

3.1 Our Financial Lives Survey shows that most UK adults (82%) have one or more general insurance products. Retail general insurance products include home (buildings and contents), motor, pet, travel, home emergency, breakdown, mobile phone and gadget insurance. According to our Financial Lives Survey, the most commonly held products are motor insurance (61% of all UK adults) and combined home buildings and contents insurance (49%).

3.2 The home and motor insurance markets generated around £18 billion in gross premiums in 2018 (ABI Household Insurance Premium Tracker), and made up 75% of the total retail general insurance sector in 2017 (ABI General Insurance Product Distribution). Many consumers need these products and drivers are legally required to have third party motor insurance.

3.3 Retail general insurance plays an important role in providing consumers with protection if something goes wrong, for example if their home is damaged or they are involved in a car accident. Sales of these products generated over £24bn in gross premiums for insurers in 2017 with the home and motor insurance markets accounting for 75 per cent of this (ABI General Insurance Product Distribution).

3.4 The home and motor insurance markets are not highly concentrated. We estimate the Herfindahl-Hirschman Index (HHI) is 589 for motor insurers and 862 for home insurers, with the top 5 insurers accounting for around 48% of gross written premiums (GWP) in motor and 57% of GWP in home. For both motor and home there is a long tail of smaller firms.

### Home insurance

3.5 While there is no legal requirement to buy home insurance, mortgage contracts generally require borrowers to have buildings insurance (unless they already have buildings insurance through a leasehold arrangement). The sum insured must typically be enough to meet the property rebuilding cost. In 2018, over 18m policies were written for premiums worth almost £5 billion (ABI Household Insurance Premium Tracker Q1 2019 (GWP)). 16% of UK households would like to have contents insurance but see it as something they cannot afford and 13% do not want or need insurance (Office of DWP Family Resources Survey, 2016-2017).

3.6 Consumers can choose to insure their home, its contents, or both. 66% of policy holders have a home policy with combined buildings and contents coverage (ABI Household premium tracker 2018). Additional features, cover or services, such as accidental damage, home emergency and legal expenses, can be included in a policy or can often be bought as an 'add-on' for an extra premium. Premium finance is another ancillary product. It allows consumers to pay their premium in instalments (typically monthly) rather than in a lump sum upfront – consumers usually pay more for this option.

## Motor insurance

3.7 Motorists are legally obliged to hold a valid insurance policy to cover third party risks. In 2018, over 27 million UK motor insurance policies were written for premiums of just over £13bn (ABI Quarterly Motor Premium Tracker).

3.8 Consumers can buy policies that also cover fire and theft or comprehensive cover. 94% of policyholders have comprehensive cover (Mintel 2019). Extra features, cover or services, such as a courtesy car, motor legal expenses, roadside assistance, or windscreen repair or replacement, can be included in a policy or can often be bought as an 'add-on' for an extra premium. As with home insurance, consumers can also use premium finance for motor insurance.

## Providers of home and motor insurance

3.9 Providers of home and motor insurance can play different roles in supplying cover. Figure 3 below shows these and the activities that firms can carry out in each role:

***Figure 3: Types of roles firms play in supplying home and motor insurance***

| | | |
|---|---|---|
| 1. | Insurers | Design, manufacture, underwrite and distribute insurance products. |
| 2. | Intermediaries (excl. PCWs) | Possible activities: Design, manufacture and distribute* insurance products but NOT underwrite risk. |
| 3. | PCWs | Intermediated platform which allows consumers to compare insurance products. |

* Some intermediaries only provide their brand name and customer base and earn commission or part of the premium.
Source: FCA analysis based on information gathered from insurers and intermediaries

## Different business models across firms

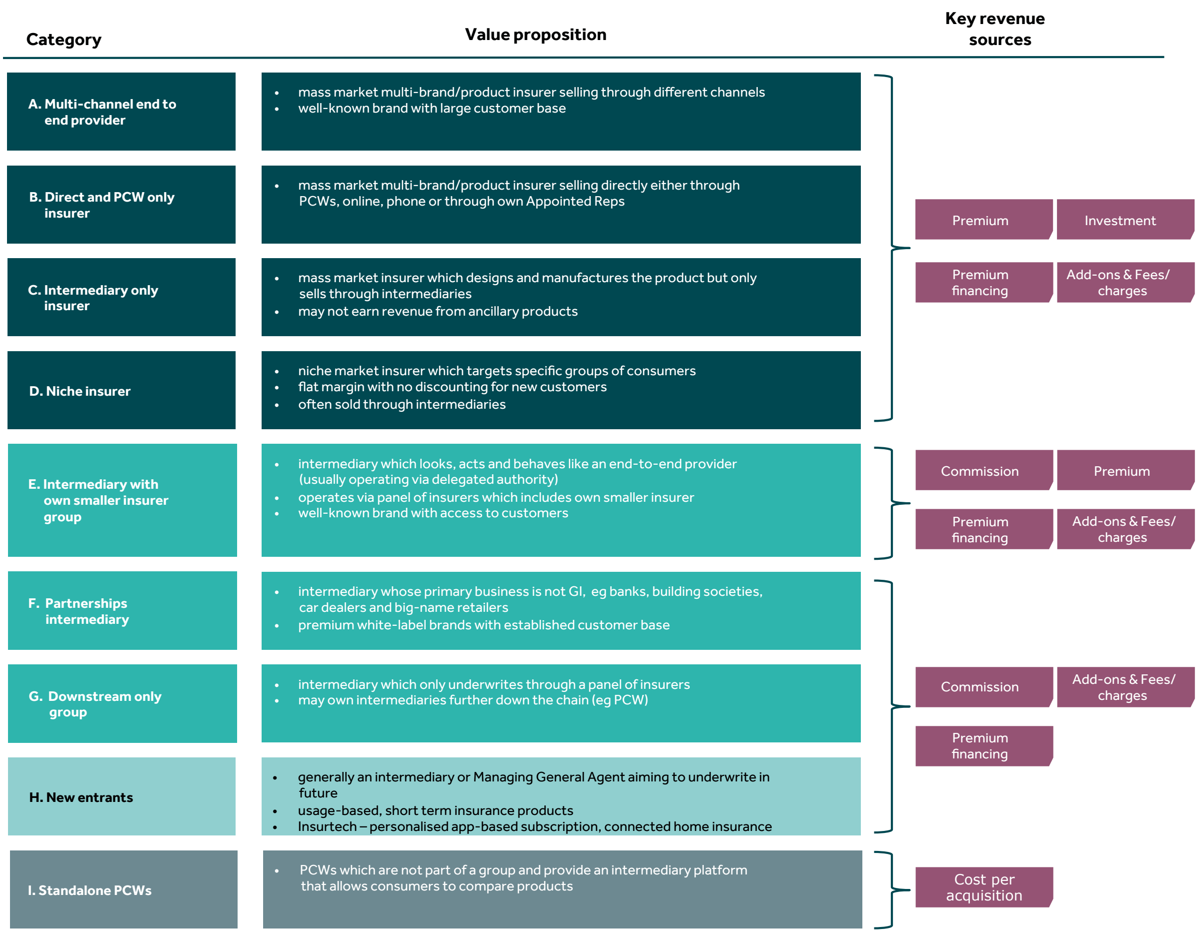
3.10 Price setting roles can vary across the supply chain, but broadly fit into the following categories:

- 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 (known as delegated underwriting authority) and the retail price.

3.11 A net rated price is the price provided by an insurer to an intermediary who then sets gross rated price (final retail price paid by the consumer pre-Insurance Premium Tax (IPT)). The net rated price usually includes the risk price plus a profit and expense margin. The intermediary adds its own commission or expenses to the net rated price to arrive at the final retail price.

3.12 As well as carrying out different roles in supplying home and motor insurance, firms also have different business models with insurers having much more stringent capital requirements than intermediaries. Figure 4 summarises the range of business models we see across insurers and intermediaries. We found that firms in our sample may use one or more of these business models.

*Figure 4: Summary of different business models across firms*



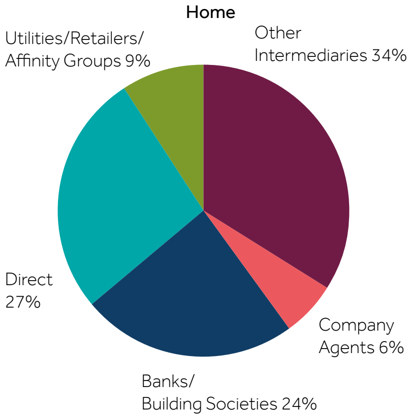

Source: FCA analysis based on information gathered from insurers and intermediaries[1]

## Distribution channels for home and motor insurance

3.13 Different events can trigger consumers' purchase of motor and home insurance, including buying a car or home or renewing of an existing policy. Consumers can do this directly with insurers in person, over the phone or via the insurer's website, or indirectly through a PCW. They can also purchase cover through an intermediary.

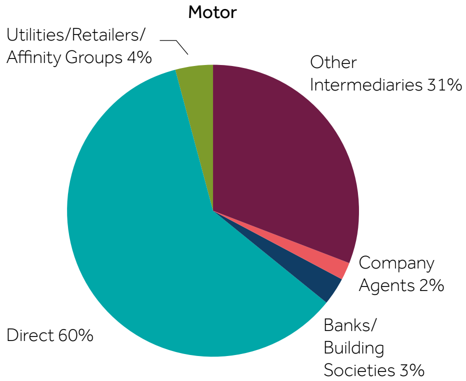
1 A managing general agent (MGA) is a specialist insurance intermediary that has delegated authority from an insurer. This delegated authority allows an MGA to perform certain functions ordinarily handled by an insurer such as taking on risk, pricing and settling of claims.

*Figure 5: Home insurance distribution by channel for insurers*




Source: ABI General Insurance Product Distribution 2017 (GWP)

*Figure 6: Motor insurance distribution by channel for insurers*




Source: ABI General Insurance Product Distribution 2017 (GWP)

**3.14** Figure 5 and 6 above shows the proportions of policies distributed through different channels for motor and home insurance. Consumers are more likely to buy motor insurance direct from insurers or specialist intermediaries (includes PCWs). Retailers, lenders and mortgage brokers are more likely to distribute home insurance, often selling it alongside a mortgage, and have a greater share of this market.

## The role of PCWs

**3.15** Often, consumers buy insurance from an insurer or intermediary after comparing prices on a PCW. PCWs provide an online comparison service to customers on a range of products and are an important distribution channel for both motor and home insurance. 13% of all home insurance policies and 31% of all motor insurance policies are sold through PCWs. Our analysis looks at how PCWs are earning their revenue, their marketing and acquisition cost, and profitability.

**3.16** PCWs earn revenue primarily from referral fees. Our international comparisons work also highlighted that the use of PCWs is comparatively high in the UK compared to other countries. This is driven by relatively strong engagement with these sites from both consumers and firms, which is not always the case in other countries.

**3.17** As PCWs are such an important distribution channel, they could affect the dynamics of the market in several ways:

- Intensify price competition at new business: All PCWs order search results by price (lowest to highest) with key product features and the brand also displayed. This ordering makes price competition more intense at new business.
- Additional costs to providers: PCWs earn revenue from acquisition fees paid by product providers when consumers click through to a provider's website and buy a motor or home insurance product. They also earn revenue from affiliate marketing agreements. The cost per acquisition (CPA) varies by products and providers. Consumers do not need to pay PCWs to do a price comparison. But because providers of insurance pay PCWs when there is a sale, these costs need to be accounted for in the price paid by the consumer for the policy.
- Vertical integration: Of the four largest PCWs, two are part of groups that also include large insurers or intermediaries. Both are operated at arm's length with the aim of managing potential conflicts of interest.

3.18 The CMA's market study on digital comparison tools (including PCWs) found that consumers use these tools to save time, money and to find a better deal. The Government's response to the CMA acknowledged that digital comparison tools are 'mostly a force for good and that they make it easier for consumers to shop around and improve competition, spurring lower prices, higher quality, innovation and efficiency'.

## Current market environment

3.19 The motor insurance market was relatively soft for much of 2018, meaning that insurers have excess capacity to underwrite business. This can put pressure on firms to lower premiums to attract consumers who are shopping around.

3.20 Motor insurance premiums peaked in 2017 when the Ogden rate was reduced to minus 0.75%. This is a discount rate that insurers use to calculate the net present value of future costs/losses a claimant will incur due to personal injury or death. Premiums gradually fell throughout 2018. This is likely to have been driven in part by the Civil Liability Act 2018 reforms on whiplash which, amongst other changes, set a fixed amount on whiplash compensation claims.

3.21 As part of the Civil Liability Act 2018, the government also legislated to revise the Ogden rate upwards from minus 0.75%. The market was expecting a revision of the Ogden rate to 0%, but the July 2019 announcement only increased the rate to minus 0.25%. Some motor insurers have warned that premium rates may rise because of the announcement, which is expected to squeeze firms' profitability.

3.22 The home insurance market is also soft, but is more stable in terms of premiums than the motor insurance market. Firms told us that this is because of relatively benign weather conditions since Q2 2016. However, storms and flash flooding followed by a very hot summer in 2018 did result in a spike in subsidence claims which damaged firms' profitability. Firms' profitability is expected to continue to be squeezed in 2019 because of the soft market conditions and an increase in weather-related claims.

3.23 The impact of a soft market is that profitability for both insurers and intermediaries is squeezed due to lower premiums. However, PCWs are less likely to be affected by market pricing changes as they charge a fixed fee per policy acquired through their comparison site.

## Future market developments and innovation

3.24 Some firms have indicated that they are making changes to their business strategy and pricing practices to drive fairer outcomes at renewal for existing customers. At least two firms have tested or launched products designed to increase the transparency of renewal pricing. One includes a commitment to ensure that a renewal price is at least as competitive as an equivalent new business price. The other fixes the customer price for 3 years.

3.25 General insurance pricing is increasingly using customer data. This could potentially lead to benefits to consumers. For example, if it enabled insurers to assess risks more accurately, they could price insurance more accurately and offer insurance to consumers previously seen as too risky to insure. However, it also brings risks. More accurate pricing may lead to some consumers being considered too risky and becoming uninsured. It could also allow firms to more accurately identify individuals who they could charge higher prices to, for example by being able to more accurately identify those less likely to switch.

**3.26** We also looked further at emerging new business models and how they could impact on pricing. Some of the key developments identified were:

- On-demand insurance: Allows consumers to buy coverage when they need it and only for as long as they need it.
- Usage-based insurance: Pricing based on how individual consumers act or use insured assets. For example, using telematics to monitor when and how a consumer drives.
- Value added services: Some insurers include non-insurance products alongside insurance. For example, providing discounted equipment or accessories.
- Auto-switching: Using artificial intelligence to automatically shop around for the best deals on a consumer's behalf. The technology can then switch the consumer to the better deal, saving them time and effort.
- Embedded insurance: Insurance that is included within another product. For example, insurance included when a car or mobile phone is purchased.

# 4 How firms set prices and treat their customers

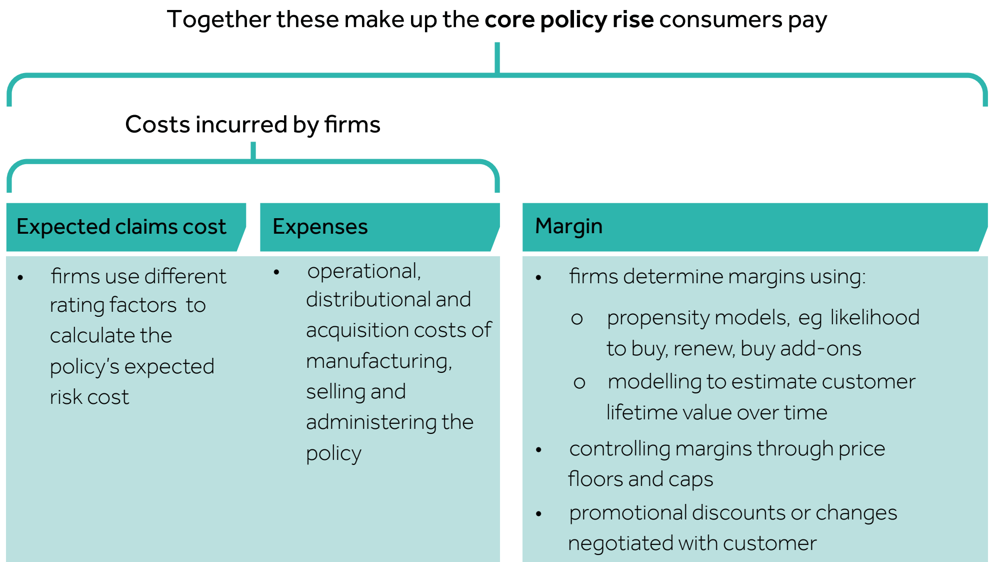
**4.1** Most firms adopt pricing practices that set different prices at new business and renewal. Firms typically aim to predict the likely behaviour of consumers when setting the price, taking account of their competitors' pricing.

**4.2** When firms offer a new business price, they may take into account the long-term profitability of the consumer. This will depend on the potential income from selling ancillary products such as add-ons, premium finance and the likelihood that a consumer will renew in the future at a higher price and continue to buy the add-on products. New customers typically benefit from low prices for core home and motor insurance policies, which are sometimes below cost. Firms seek to recover any initial losses by increasing the customer margin (the amount of the price charged above or below the cost of underwriting the risk and serving the policy), and thus the price, at renewal. After they make back the initial discount, many firms continue to increase customer margins on renewal. This is referred to as 'price walking'. Most firms in our sample operate a price walking strategy.

**4.3** As firms set prices in this way, prices for renewal customers can after a few years become considerably higher than those charged for new customers and also the cost of supplying the insurance. Consumers who do not respond to price increases at renewal by switching or negotiating the price with their provider usually pay more, even if it costs the same to supply them with insurance.

**4.4** Most firms in our sample who have a role in setting prices told us they apply the same pricing practices to motor and home insurance. Figure 7 summarises the way most firms in our sample set prices, and the components that make up the retail price that consumers pay (excluding IPT). Consumers can also buy optional ancillary products or take premium finance which can increase the total price consumers pay.

***Figure 7: The components of price (excluding IPT)***




Source: FCA analysis based on information gathered from insurers and intermediaries

**4.5** A firm's pricing model often determines the number of renewals required before the price reaches target margins (as well as the level of any initial discount for new customers). Most firms in our sample use some form of cap, such as on margin or commission, to limit how much prices charged to individual customers can rise above costs.

**4.6** We also found that firms vary in the level of complexity and sophistication of their pricing. A small number of insurers and intermediaries charge the same margin to each customer group, for example when distributing through a particular channel or partner. In these cases, firms are more likely to seek a profitable margin on both new and renewal business.

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

## Margin optimisation

**4.8** Margin optimisation is a process where firms adapt the margins they aim to earn on individual consumers. Firms' pricing strategies can change over time and the aim of the optimisation process will depend on the strategy they are seeking to achieve. Examples include maximising profit, retention, conversion or customer numbers. Both insurers and intermediaries, with delegated underwriting authority to undertake risk pricing, typically use different pricing models in risk pricing and margin optimisation. In our sample, most firms used lifetime value and propensity models (conversion, retention, and ancillary product models) as part of their pricing.

**4.9** The main propensity models we saw from firms in our sample were:

- Conversion models: These assess the expected number of sales of both the core policy and ancillary products compared to the number of quotes at new business. Firms model the impact of changes in the price on conversion rates for different consumers or groups of consumers.
- 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 use these to model the expected impact of price changes on customer retention rates as a core input to assessing the price they wish to charge (including as part of lifetime value modelling).
- Ancillary product models: Firms offer ancillary products (add-ons) or premium finance alongside a core insurance policy. Firms may incorporate predictions of ancillary income into their pricing decisions.

**4.10** We found that firms used margin optimisation for both new business and renewal pricing.

**4.11** Firms set prices to maximise growth or profitability, taking account of a consumer's willingness to pay, likelihood to buy/renew or buy add-ons. The information used in the model includes customer characteristics gained both from information provided by the customer and wider externally available information. Firms also take account of other factors such as the distribution channel, or product purchased, to estimate how likely a customer will be to buy and renew at different price levels over time. If the renewal price is too high, consumers are more likely to buy from a rival.

4.12 While margin optimisation, a form of price discrimination, may be profitable for an individual firm, it does not necessarily benefit consumers. Consumers who are more price sensitive pay less, while those who are less price sensitive pay more. In addition, price discrimination can increase or reduce price competition (and lower or increase average prices to consumers), depending on the type of price discrimination deployed. This is discussed in more detail in chapter 5.

### Lifetime value modelling

4.13 Lifetime value modelling (LVM) allows firms to assess the current and future value of a customer or customer segment. Firms assess the net present value of a customer to help them choose prices that will be profitable over the lifetime of the customer relationship. The lifetime value of a policy is calculated by combining expected income from the core policy, including from potential renewals, with relevant add-on income and then deducting costs. The resulting values inform pricing decisions and help firms to estimate the level of acquisition and marketing spend.

4.14 The lifetime value model uses historic data to assess the future value of various distribution channels and brands when deciding policy. This can also allow firms to determine the aggregate possible losses on core underwriting, for example on new business, while ensuring that their pricing strategy is profitable overall. Where lifetime value models directly inform pricing, they use customer conversion and retention information as a direct input.

4.15 We found that lifetime value models the firms in our sample used assume a longer tenure for home insurance than motor insurance. A shorter lifetime value means that firms need to meet overall profitability targets in a shorter timeframe.

### Price testing and benchmarking

4.16 Firms also monitor the prices their competitors set and use price testing to continuously test the impact of small changes in the prices charged in the market on consumer conversion and retention rates. This helps firms to understand market competitiveness and maintain an up-to-date understanding of consumer behaviour affecting propensity and hence pricing models.

## How firms treat consumers

4.17 As well as understanding how firms set prices, we looked at how firms treat their customers and consider them when setting prices. We looked particularly at:

- How firms consider outcomes for different groups of consumers. This includes how they treat consumers who are vulnerable or paying very high prices.
- Whether firms provide consumers with clear and accurate information when they renew their insurance. We looked at the impact firms' practices have on consumers' ability to make informed choices and act to get better deals.
- The impact of contractual terms, such as auto-renewal.

## Consideration of outcomes for different groups of customers

### Use of rating factors and customer data

4.18 Firms use numerous rating factors in their pricing models gained from both internal data (including data direct from the consumer) and externally derived information/data sets. The number of factors used by firms in their pricing models ranged from under 50 to over 400.

4.19 Firms apply risk rating factors to data on customers' risk characteristics to calculate the expected claims cost. Most also use optimisation rating factors to optimise the final price based on customers' propensity to purchase, renew or buy ancillary products or services. Among the factors used by firms to set final price or optimise margins, we found the following:

- Factors that are also used for pricing risk, such as whether a property has a smoke detector, the number of children in the family or policyholder age. These data are usually supplied by customers when buying insurance.
- Factors possibly unrelated to risk including, for home insurance, customers' occupation, where they shop and what else they buy. This data may be supplied by customers, or obtained with their consent.
- Factors relating to customers' buying and media habits, including their browser type, time of day and also the month they buy the policy.
- Factors relating to credit scores, including credit search history. The data are obtained from credit agencies.
- The type and level of cover purchased, including whether a home policy includes accidental damage and whether the policy auto-renews.
- The brand (of insurance) chosen by the customer.

4.20 Firms told us that they may use additional customer information they gather over time to price renewal business more accurately. A few firms also use these additional data to manage their customer book and sometimes identify and decline renewal to some higher-risk customers. The additional customer data that firms acquire over time can be used in optimisation rating factors, leading to an increase or decrease in the renewal price. 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.

4.21 A few firms in our sample have reviewed the rating factors used in their pricing models. These firms have changed or discontinued the use of factors that, for example, unintentionally correlated with potential vulnerability.

4.22 Identifying vulnerability throughout a policy could be difficult as the annual nature of policies means contact is likely to be only once a year. Firms use certain factors as indicators of a customer's vulnerability. Examples include age and whether they have switched or negotiated their premium in recent years. Some firms may freeze prices or waive fees in the event of a change in personal circumstances where a customer is temporarily in a weaker position leaving them particularly susceptible to detriment.

### Use of pricing constraints

4.23 Most firms use constraints when setting renewal prices. These constraints are the main way that firms have responded to concerns about pricing practices that result in some customers who continuously renew with the same provider paying increasingly high margins.

4.24 We have seen a growing use of caps on margins earned from individual consumers. The aim of this is to reduce margin, meaning less profit for insurers and reduced commission for intermediaries. Some firms with large books of existing customers are reducing margins to within these caps. However, firms have usually chosen to make these changes over multiple renewals. This reduction is affected by firms' wish to smooth the rate of price change, and agreements with others in the supply chain that may limit the pace at which margins can be reduced.

4.25 The majority of firms have applied further constraints to protect potentially vulnerable customers. These include capping the age or tenure used in optimisation models, comparing the loss ratios for vulnerable customers to other customer groups or removing price optimisation for customers over a certain age.

### Treatment of legacy customers

4.26 Some customers hold policies that are no longer sold to new customers (legacy products). There can be significant differences in price between these legacy products and those sold to new customers. This can be because legacy customers with long tenure are less price-sensitive and hence less likely to shop around even if prices are increased at renewal. Some firms have also attributed the price differences to their holding less current information about these customers; or be due to differences in levels of cover.

4.27 A few firms have recently started reviews of these legacy products to see where there are differences between the prices or cover. As part of these reviews, some firms with large books of legacy customers are prioritising identifying and reviewing of customers paying the highest margins. These projects include:

- 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; and
- implementing a target operating ratio to align all back-book customers with new business prices.

## Governance and control over pricing

4.28 Since we published our thematic review and Dear CEO letter on general insurance pricing practices, we saw some evidence of firms focusing more on how they consider customers in their pricing practices.

4.29 Most insurers and price setting intermediaries in our sample have pricing frameworks in different stages of development and implementation. Some of these set out how they intend to treat customers when setting prices and using customers' personal data.

4.30 There has been a rise in monitoring pricing outcomes through the management information given to pricing committees and boards. Most of these currently only involve the broader treatment of customers such as complaints, claims and customer service feedback. Some firms have given their pricing committees specific responsibilities to consider the impact of pricing on different customer groups.

4.31 In some firms, pricing management information has not been fully rolled out and the reporting packs given to boards suggest metrics that will be added in the future. The few remaining firms did not provide us with evidence that they have developed management information to understand the effect of pricing decisions on different groups of customers.

4.32 Our review of firms' responses to the Dear CEO letter on pricing practices also shows that the nature, extent and quality of responses varies widely. While some firms have improved their practices, firms need to significantly improve their, governance of pricing practices.

### Price negotiation at renewal

4.33 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 quoting a single renewal offer with little or no room for negotiation. These firms said that this approach can help them treat their renewal customers consistently. Others said they would rather lose a customer than reduce their offer below a certain threshold.

4.34 The firms that allow customers discounted renewal prices have procedures that control how much discretion is allowed. For example, 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.

## Provision of information

### Differences in price between new and renewal customers

4.35 Most firms charge different prices to new and renewing customers for reasons other than risk or cost to serve. The main reason firms give for increasing price at renewal is to recover the losses that they incur giving introductory discounts to new customers, sometimes at below cost. This practice is widespread in the market, but is not always apparent to customers.

4.36 There are a couple of firms that are looking to show more clearly where quotations include new business discounts or offers, such as explaining customers how they operate, or at renewal if customers question the price. However, they do not generally explain the fact that prices are likely to increase.

4.37 PCWs sometimes show where prices are introductory or include a discount, though this is not a consistent or widespread practice. We understand that some PCWs have conducted experiments to indicate where quotes include introductory offers but had recorded low levels of customer recall and engagement.

### Renewal communications

4.38 We have implemented rules to increase transparency and engagement at renewal. These rules mean that when customers receive a renewal quote, it should set out the price they paid last year alongside the new quote. They should also be reminded to check that the cover still meets their needs.

4.39 Our rules do not require firms to explain in renewal communications why the price has changed. However, some firms included reasons for price changes, such as cost increases or changes to IPT rates. None included reasons linked to firms' pricing practices, such as the end of an introductory offer.

4.40 A number of firms told us that customers who are unhappy with their renewal offer could contact them and negotiate on terms. However, this was not mentioned in any of the renewal documents we reviewed.

4.41 Consumers who originally purchased via a PCW can be stimulated to review their options at renewal. Some PCWs contact previous customers with alternative premium indications a few weeks before the renewal. These sometimes contain promises of free gifts or vouchers to customers who switch.

## Impact of contractual terms

### Auto-renewal

4.42 Many policies contain auto-renewal clauses. Under them, unless the customer tells the firm otherwise before the renewal date, the policy will renew on the terms in the renewal invitation. This is widely known as auto-renewal. Customers can still renegotiate, amend, switch or cancel their cover up to renewal date.

4.43 Many firms emphasised the importance of auto-renewal in reducing the risk of consumers being left uninsured if they forget to renew their policy. For motor insurance, this would lead to contravening the legal requirement for valid third-party motor insurance to drive in the UK.

4.44 Our analysis of firms' data shows that auto-renewal is linked to higher prices for home insurance. We found no evidence of this link in motor insurance.

4.45 A few firms use auto-renewal as a predictor of customers' willingness to pay, in their calculation of the final price for renewals, with at least one charging higher margins to auto-renewing customers as a result. Customers choosing to auto-renew may not be aware that this could impact their premiums at future renewals.

4.46 Some communications that firms sent to customers at renewal used language that might mean customers did not have to actively make a renewal decision. For example, some auto-renewal notices stated prominently that customers need take no action if their details had not changed.

4.47 All the firms in our sample offered auto-renewal when the customer originally took out the policy. Most of these auto-renewals were on an opt-out basis, meaning customers would have to make an active choice to opt out of auto-renewal. Although accepting auto-renewal appears to require minimal effort, customers need to put more effort into contacting the firm if they wish to cancel it. In most cases, we saw firms requiring contact by phone to cancel auto-renewal, even if policies were originally taken out online.

# 5 The impact of pricing practices on competition

## Introduction

5.1 This chapter considers whether pricing practices for home and motor insurance support effective competition that delivers good outcomes for consumers. We highlight the key features of competition in the home and motor insurance markets. We then consider whether pricing practices:

- lead to price discrimination that intensifies or dampens competition.
- work in the interest of only some or all consumers.
- raise the cost of providing insurance either through generating high search and switching costs for consumers or increasing customer acquisition costs for firms (or both).
- lead to firms making high profits overall.
- increase or restrict consumers' access to insurance.
- create barriers to existing and new firms developing innovative business models and different pricing strategies.

## Features of price competition in home and motor insurance markets

5.2 The key dynamics we see in both the home and motor insurance markets are:

- Price discrimination by optimising the margin. Nearly all firms set different prices to new and renewal customers (through discounts to new business) and customers of different tenure (by price walking). They also set different prices to different customers of the same tenure based on their estimated willingness to accept a given price offer (through price optimisation).
- Prices also vary depending on the distribution channel and the competitiveness of the market at any point in time.
- Price is perceived to be the most important reason for choosing a provider, although brand is a strong contributory factor for a substantial minority of customers.
- A lack of pricing transparency (including reasons for price changes) means that consumers are unable to know how competitive their price offer is unless they search.
- Less engagement with the non-price (qualitative) elements of a policy due to a lack of available information for consumers to make decisions about quality.
- Consumers undertake different degrees of search at renewal. Some search extensively for the best deal each year. Others may search more periodically or are only prompted to search or negotiate when they become aware that their offer may not be competitive. Others renew without shopping around.

- Consumers who compare prices and negotiate or switch where necessary tend to get a better, or potentially significantly better, deal than those who do not shop around and renew with the same provider each year.

## Price discrimination can intensify or dampen competition

**5.3** Price discrimination can have different effects on the nature and intensity of competition.

**5.4** It can intensify competition by allowing firms to offer discounts to their rivals' customers. This increase in competition benefits consumers as a whole as far as it reduces the average price paid for insurance. However, not every consumer necessarily benefits from this increase in competition. This is because price discrimination also changes the nature of competition. Consumers who are more willing or able to switch brands to get a good deal pay lower prices than those with higher switching costs or a stronger preference to remain with their current brand.

**5.5** However, price discrimination can also dampen competition, increasing the average price paid by consumers. This is most likely to happen where higher prices are charged to those consumers who lack awareness that the deal they are offered is not competitive, while lower prices are offered to more informed consumers. Examples of where price discrimination can dampen competition include where higher prices are charged to consumers who are less aware of current pricing practices because 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 (e.g. based on its brand) 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.

**5.6** So the impact of price discrimination on competition depends on why some consumers are charged higher prices. Price discrimination is more likely to have beneficial effects on competition where consumers make informed decisions about whether to search and switch. It is more likely to have negative effects where consumers lack awareness about the competitiveness of the price they have been offered or the ability to act to get better deals. Both types of price discrimination may take place at the same time so that the net effect on competition may depend on which type of price discrimination dominates.

**5.7** The competitive effects of price discrimination also depend upon which firms can identify profitable customers. If, for example, all firms can identify which consumers are likely to be the most profitable, then they will compete hard to attract these customers by offering them highly competitive prices. But, if only the current firm can identify which consumers are the most profitable, rival firms will not be able to offer these customers with lower prices and so competition will be less effective.

**5.8** Competition tends to be more effective when firms are able to 'find' profitable consumers, than when profitable consumers need to 'find' firms in order to secure competitive prices. The reason for this is that some consumers may not be aware that they are paying high prices (and are therefore profitable), so they may feel they do not need to search.

**5.9** Firms have told us that they price discriminate based on the propensity of a customer to renew their insurance product and their lifetime profitability. In effect, this implies that consumers are offered prices based on their estimated price elasticity of demand (or consumers' sensitivity to changes in price). We use price elasticity here in the sense of the willingness to pay for the products from a particular firm or brand, rather than for the product more generally.

**5.10** However, a consumer's price elasticity of demand is based on a range of factors including the consumer's:

**a.** switching costs
**b.** brand preference
**c.** awareness of the competitiveness of the product they have been offered

## Assessment of whether firms price discriminate for home and motor insurance based on switching costs or brand preference

**5.11** Consumers may be making informed decisions to pay higher prices to stay with their current provider to avoid the effort of shopping around or because they value their current brand. However, a rival firm could offer a competitive price which would trigger a consumer to change provider. This means firms can still compete for these customers by offering discounts at new business.

**5.12** If price discrimination is happening based on a consumer's informed preference to stay with their current supplier, then we would expect to see a positive relationship between customer margins and switching costs and/or brand preference.

**5.13** We estimated individual consumer switching costs using a technique known as contingent valuation. We asked respondents to estimate the amount they would be willing to save to switch provider or spend to avoid switching. We provide a more detailed explanation of how we calculated search and switch costs in the Consumer research – technical report.

**5.14** We examined whether consumers with the highest switching costs were more or less likely to be charged a higher margin. We find no evidence of any positive relationship between switching costs and margin in either home or motor insurance. These results may reflect the fact that switching costs are difficult to estimate and that firms do not directly track them.

**5.15** However, our consumer survey shows that consumers who knew they could get a better deal but did not think the potential savings were worth the hassle of shopping around paid higher margins than those who believed their deal was amongst the lowest price on the market. For home insurance, the median margin paid was 14% points higher, and for motor 5%.

**5.16** We ranked consumers by the margin they paid and split these into ten equal sized groups (deciles). The group who paid the highest margins (top 10% of sample) we defined as "highest", and the group who paid the lowest margins (bottom 10% of sample) we defined as "lowest". We use this definition throughout this report.

5.17 We also see a link between margins and some measures of brand preference. For example, firms often offer substantial discounts to customers of rival firms to encourage them to switch away. These discounts – which are often made online – are naturally targeted at those consumers who are considering switching. These consumers may simply be more aware of the benefits of search. But they may also be more prepared to switch brands to get a good deal. For example, our consumer survey found that home insurance customers who were prepared to switch regularly to get a good deal were over twice as likely to be paying the lowest margins compared to customers who preferred the comfort of being with a brand they know and trust. However, we do not observe any similar relationship between brand preference and margin in motor insurance.

5.18 We also see evidence from our consumer survey that some consumers are willing to pay a premium for a trusted brand. Again, the effect is greater for home insurance where the median margin paid was 39% for consumers who prefer a brand that they know and trust compared to a margin of 28% for consumers who preferred to pay a lower price. 64% of those paying the highest home insurance margins prefer the comfort of a brand they know and trust compared to just 33% for those paying the lowest margins. For motor, this effect is less apparent 49% of those who pay the highest margins preferring a trusted brand compared to 44% for those paying the lowest margins.

5.19 These effects may simply reflect well-known brands charging higher average prices than other firms. In contrast, price discrimination based on brand preference requires a firm to charge higher prices to those of its consumers who value its brand most highly, and low prices to those who are more willing to switch brands to get a good deal.

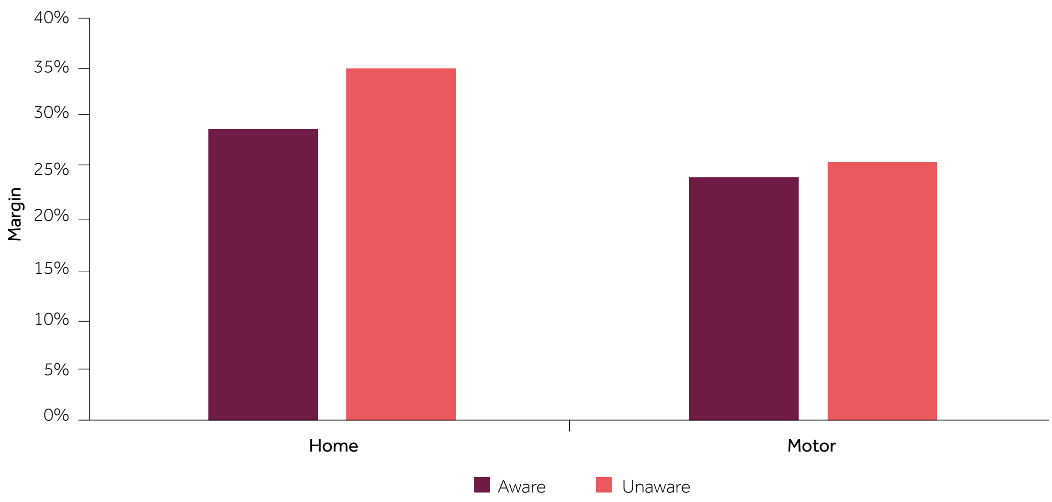
## Assessment of whether firms price discriminate for home and motor insurance based on consumer awareness

5.20 We would be concerned if firms price discriminate for renewal customers based on consumer awareness. If a consumer naively believes they are getting a good deal when they are not, they will not shop around for a better offer. Consequently, this type of price discrimination reduces firms' incentives to offer lower prices to these consumers.

5.21 We found strong evidence 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. They are also least aware of how competitive their current deals are. This holds true in both the home and motor insurance markets, but the relationship in motor insurance was less marked.

5.22 We found that 55% of consumers in home and 57% in motor can be classified as someone who may not be aware of the competitiveness of the product they own, given current pricing practices. That is, they gave 2 or more answers to the survey that indicates they lack awareness about how pricing works in the particular market. As shown in Figure 8, for home, these consumers were paying 6% points higher margins than those not in this category. For motor, margins were 1% point higher for these consumers compared to those not in this category.

*Figure 8: Differences in margins between aware and unaware consumers*




**5.23** We would be less concerned if firms can identify specific profitable consumers (including those with low awareness) at new business and offer that consumer much lower new business prices. Under these conditions, because of deep discounts at new business, firms would make no or low margins over the consumer's tenure.

**5.24** Firms told us that they compete intensively to attract consumers who they expect to be more profitable over time (lifetime value). However, we have observed little evidence, from our initial analysis, that consumers who appear to be less aware (and so may be more profitable later in their tenure) pay different margins at new business than other similar consumers who have greater awareness. We will consider this further, including whether we can identify how much individual consumers pay over time, to inform our final report.

## Conclusions on impact of price discrimination on competition in home and motor insurance

**5.25** We see some evidence of price discrimination based on the willingness of consumers to switch brands to secure a better price deal. This strengthens competition as firms can compete for some customers by offering discounts at new business.

**5.26** However, we find that firms also price discriminate based on consumers' awareness of how the market works and how good their deal is. Firms earn higher margins from consumers who are less aware. This type of price discrimination is likely to have a negative effect on competition because unaware consumers will not shop around for a better deal and so firms cannot compete for these consumers.

**5.27** While firms have told us that they compete more intensely for more profitable consumers, our initial analysis has not found that consumers who appear to be less aware (and so may be more profitable later in their tenure) pay lower margins at new business than other consumers.

## Assessment of whether competition for home and motor insurance leads to high costs for consumers and firms

**5.28** The current practice of discounting new business premiums followed by increasing rates in subsequent years means that consumers must search each year to ensure they don't pay more than necessary. This means consumers pay a search cost in terms of time and effort.

**5.29** As this pricing practice also increases customer switching, firms will also incur additional marketing and customer acquisition costs. While some degree of shopping around and switching can be good for competition, too much can impose unnecessary costs on consumers and firms. This can lead to higher prices overall.

**5.30** It is not possible to give a precise level at which search and switching is good for competition or causes consumer harm. However, we find that firms are price discriminating primarily based on customer awareness. This forces customers either to incur the costs of becoming aware by searching each year and negotiating or switching if necessary, or risk paying with an uncompetitive price.

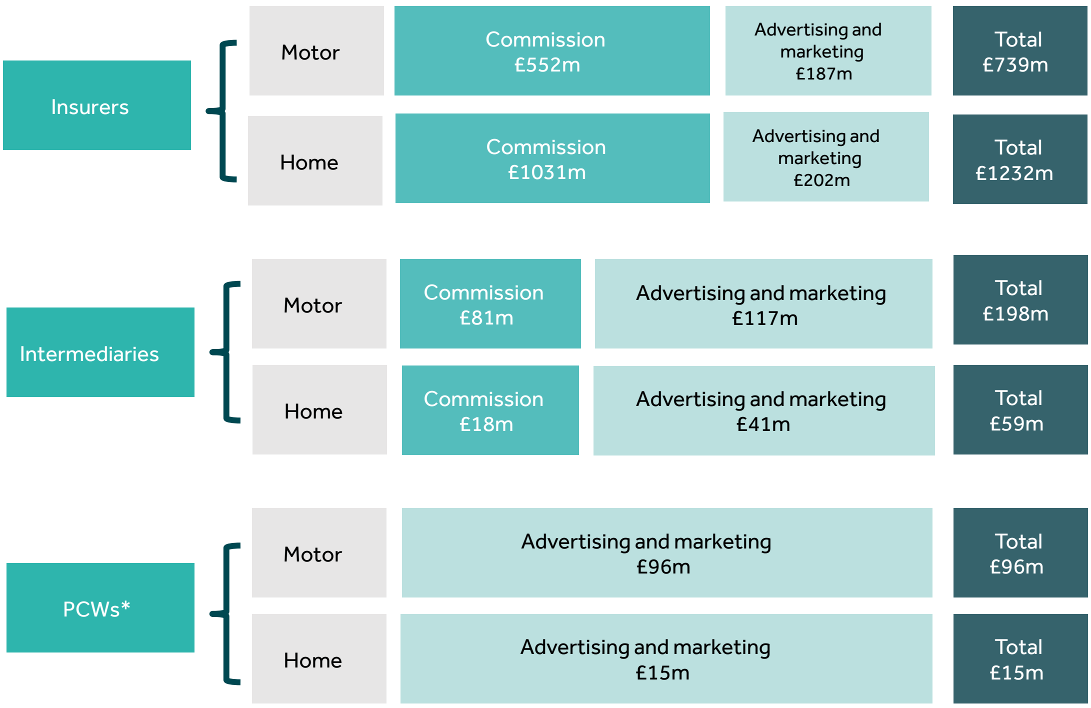
**5.31** In our consumer survey, we estimated these costs using contingent valuation. Search and switching costs can have different effects on competition, so we estimated them separately. The way a question is framed can also affect consumer responses, so we asked questions in both in a positive (£ saved) and negative (£ spent) frame.

**5.32** Taking an average of both the positive and negative frame results, we found that respondents' valuation of search effort was similar in both home and motor. It was £18 in home and £20 in motor. Respondents' valuation of switching time and effort was £20 per year in home and £22 in motor resulting in combined search and switch costs of £38 in home and £42 in motor, or 21% of the average premium in home and 13% in motor. These figures vary slightly with our consumer survey report due to differences in methodology and access to premium data.

| | Home | Motor |
|---|---|---|
| **Average search cost** | £18 | £20 |
| **Average switch cost** | £20 | £22 |
| **Average combined search and switch cost** | £38 | £42 |
| **Percentage of average premium** | 21% | 13% |

**5.33** Switching also results in a cost for firms, including spending money on advertising to win new business, commissions and processing costs. Our analysis of financial data from firms in our sample shows that customer acquisition costs, including marketing expenditure, are the second largest cost to firms after claims costs. These costs expenditures are spread through the distribution chain, as shown in Figure 9 below.

*Figure 9: Breakdown of acquisition costs across the home and motor insurance supply chains*




Source: FCA analysis of information provided by firms

*For PCWs, the acquisition cost relates only to direct cost, as firms found it difficult to split allocate costs by motor and home.

5.34 We found that home insurers spend significantly more on acquisition cost (29% of premiums) relative to motor insurers (7% of premiums). While all firms provided figures for commission, only 9 out of 14 motor insurers and 12 out of 16 home insurers provided us with data on advertising and marketing.

## Assessment of whether pricing practices lead to firms making high profits

5.35 We have analysed profitability as it can indicate whether competition is working well in the market. Many firms (insurers and some intermediaries) are balancing losses on new business customers with higher margins charged to longstanding customers. Our analysis of financial data from the firms in our sample shows that, on average, firms make positive accounting operating profit margin for both motor and home insurance. The level of profitability of certain activities varies across home and motor insurance. Due to challenges around the firms' ability to split their balance sheet items meaningfully by products, we have focused on using conventional industry performance ratios and accounting pre-interest and tax operating profit (including revenue/profit from sources like investment, add-ons and premium financing) as indicators of profitability in our financial analysis.

### How firms generate revenue for home and motor insurance

5.36 Over the period 2013 to 2018, insurers in our sample earned, on average, £7 billion in premium revenue for motor and £4 billion for home. Non-core revenue contributes about £2 billion. Insurers' primary source of revenue is premiums received from policies sold to insured customers. Intermediaries primarily arrange policies for the insurer hence their main revenue source is commission earned for the placement of policies. Both insurers and intermediaries also generate revenue from other sources, like add-ons and premium finance. We have defined this as non-core revenue.

**5.37** Figure 10 below shows the different sources of revenue across the supply chain.

***Figure 10: Summary of costs, revenues and sources of profit for different firms across the supply chain for home and motor insurance***

| | Income | Costs | Profit |
|---|---|---|---|
| 1 Insurers | • Core income: Net earned premium<br>• Non-core income: Investment income, premium finance, add-ons, fees and charges. | • Claims cost<br>• Expenses: acquisition cost (commission paid, CPA and advertising & marketing), staff costs, other operating costs (including add-ons claims cost and default cost). | • COR: Underwriting profitability (>100% is loss making on underwriting)<br>• Operating profit: overall profitability of the business |
| 2 Intermediaries (excl. PCWs) | • Core income: Commission<br>• Non-core income: Add-ons, premium finance, fees and charges. | • Expenses: commission & CPA paid, advertising & marketing, staff cost, other operating costs. | • Operating profit: overall profitability of the business |
| 3 PCW | • Core income: Cost per acquisition (CPA) | • Expenses: advertising & marketing, staff costs and other operating costs. | • Operating profit: overall profitability of the business |

Source: FCA analysis of information provided by firms

Combined operating ratio (COR) is a measure of underwriting profitability. This is computed as a percentage of the premium that the insurer pays out in claims and expenses.

Cost per acquisition (CPA) is the fee that PCWs earn when a consumer successfully buys a new product on the provider's own site after being directed from the PCW platform.

Net earned premium (NEP) is the sum of premiums written minus premiums ceded to reinsurance companies.

## Accounting profits for home and motor insurance

**5.38** Over the period 2013 to 2018, we observe that profitability varies depending on the activity being carried out by the firm.

**5.39** For insurers, we observed that underwriting of the core insurance product is marginally profitable for home insurance and generally loss-making for motor insurance, based on the combined operating ratios provided by firms, and we also note that this is over a relatively benign weather period. There are exceptions to this; we found that in motor there are certain business models which enable the firm to earn positive profits from underwriting.

**5.40** However, revenue from non-core sources led to additional profits:

- On average, home insurers receive £231 in premium per policy each year. This equates 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.

- Motor insurers receive, on average, £299 in premium per policy each year but only make £2 core product underwriting profit per policy as calculated using firms' financial data submissions. Adding non-core revenue sources, motor insurance firms earn an extra £45 profit, taking overall profit to £47 per policy. This suggests that motor insurers depend on revenue sources which are ancillary to their underwriting activity for profitability.

**5.41** Large insurers with multiple brands and sales channels tend to have lower profitability. Specifically, the top 5 motor insurers by income have an operating profit margin of 11% while the remaining firms have an operating profit margin of 19%.

**5.42** The average proportion of new to renewal business in terms of GWP is 50/50 for motor insurers and 20/80 for home, highlighting that a higher proportion of home customers tend to stay on with an insurer than switch. We find that firms with a higher proportion of renewal business have higher operating profit margin.

**5.43** We observed that the top 5 home insurers with the largest proportion of customers paying high or very high customer margins[2] also have the highest operating profit margin when compared to the other firms in the sample. We do not see a similar trend for motor insurers.

**5.44** On average, 14% of total revenue earned by motor insurers is from non-core sources. This translates to about £1.1 billion per year. Non-core revenue makes up 7% of total revenue or £346 million per year for home insurers. Motor insurers with a higher proportion of non-core revenue (e.g. investment income, add-ons and premium finance) have higher operating profit margin. We do not see a similar trend for home insurers.

**5.45** We found that premium financing can be quite significant for some firms. In our insurer sample, 18% of motor policies and 11% of home policies are sold premium finance.[3] There is wide variation in income earned per policy on premium financing between firms. We see that in motor, firms earn between £3 to £110 per policy on premium financing. In home insurance, firms earn between £3 and £32 per policy on premium financing. This variation is because firms use various methods to set the annual percentage rates charged as well as the fact that there could be wide variation in premiums (e.g. young drivers will have much higher premiums).[4] Some firms also adapt the price charged to consumers based on both the customer's likelihood of taking out ancillary products. For instance, firms have told us that they are likely to charge lower premiums on the core product if the customer is likely to buy an add-on.

**5.46** Information from 10 insurers showed legal expenses cover is the main add-on revenue earner for both motor and home. We note that direct and PCW only insurers have a higher proportion of add-on revenue compared to the other firms. A possible reason could be that such firms keep headline prices low in order to compete and also that add-on revenue for intermediary business will be earned by the intermediaries.

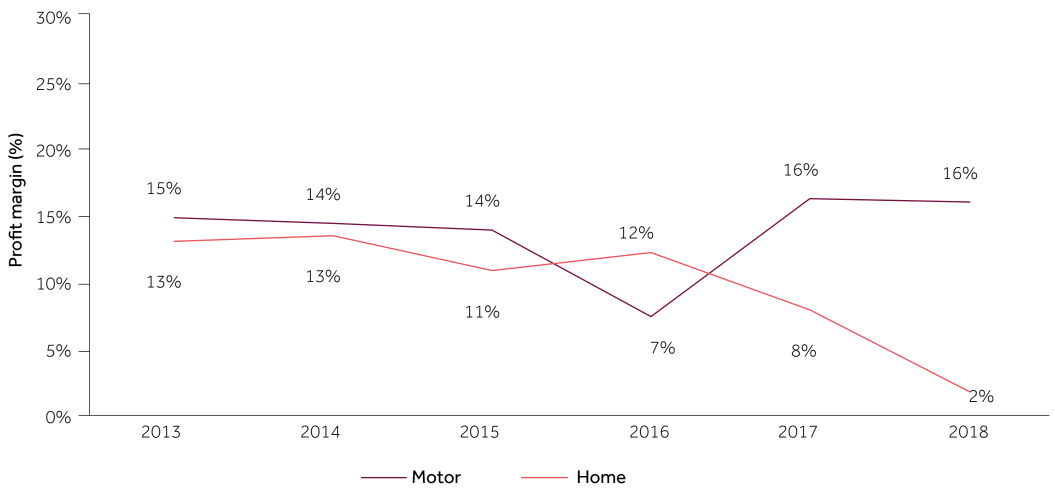
2 High and very high margins – defined in para 6.33

3 To note that some intermediaries will be earning premium financing revenue which is not being reflected in the insurers' accounts. Hence the percentages of premium financing being sold could be higher.

4 This includes: a flat charge; a variable charge dependent on risk; charge which is aligned to the Bank of England base rate and where the charge varies according to the distribution channel and policy type.

5.47 Figure 11 shows the overall operating profit margins of insurers in our sample from 2013 to 2018. This is reflective of accounting profit and does not include the opportunity cost of capital.

***Figure 11: Overall operating profit margins of insurers (2013 to 2018)***




Source: FCA analysis of financial data provided by firms

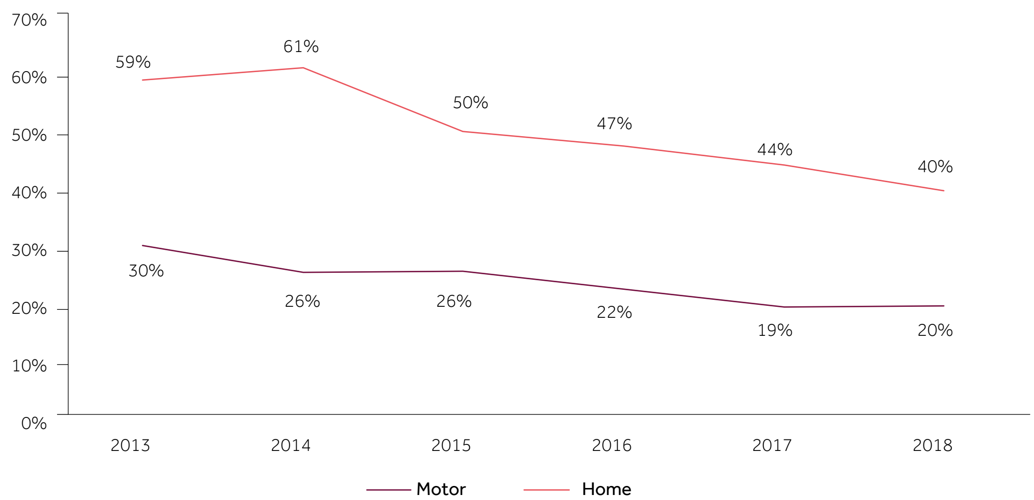
5.48 Intermediaries earn on average higher operating profit per policy than insurers:

- For home insurance, intermediaries in our sample earned £58 per policy, resulting in an average per policy profit of £39.
- Motor intermediaries in our sample earn on average £31 per policy, resulting in an average profit per policy of £24.

5.49 Motor intermediaries earn 53% of total revenue from non-core revenue compared to 25% for home. Premium financing is the highest non-core revenue earner for motor, while add-on is the highest for home. Specifically, legal expense cover is the largest component of add-on revenue for both motor and home intermediaries.

5.50 Figure 12 shows intermediaries overall operating profit from 2013 to 2018:

***Figure 12: Overall operating profit of intermediaries (2013 to 2018)***

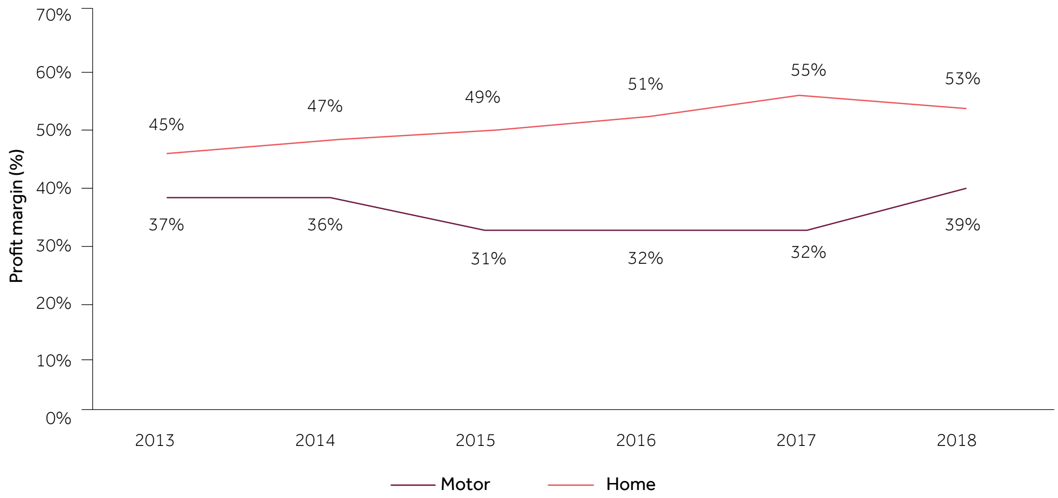



Source: FCA analysis of financial data provided by firms

**5.51** PCWs earn operating profit for motor and home:

- For home, PCWs in our sample earned £45 per policy, resulting in an average per policy profit of £17.
- For motor, PCWs in our sample earned £51 per policy, resulting in an average per policy profit of £16.

***Figure 13: Overall operating profit of PCWs (2013 to 2018)***




Source: FCA analysis of financial data provided by firms

- Overall, both firms' home and motor insurance business are profitable. The level of profitability varies depending on several factors, including the activity being carried out, the firm's business model and the proportion of new and renewal business a firm has. More detail on our financial analysis is in the Business Models and Financial Analysis technical annex.

## Assessment of whether pricing practices impact on consumers' access to insurance

**5.52** Price discrimination can increase or restrict market access. We assessed what impact current pricing practices have on access and consumers' level of cover. Charging some consumers lower prices may mean they can afford insurance that they would previously have been unable to. However, if consumers do not know how to get better deals or shop around and this means they are quoted higher prices, they may decide to become uninsured.

**5.53** However, our consumer survey found that very few people would stop buying insurance because of a market-wide price increase. 6% of home insurance respondents and 5% of motor insurance respondents said they would give up insurance (or, for motor, stop driving their vehicle) if their premiums rose above their stated willingness to pay and they could not get a better deal by shopping around.

**5.54** Our analysis was limited as we only have data from consumers that are currently insured. Using 2016-2017, DWP data we found that 16% of survey respondents would like to have contents insurance but believe they cannot afford it. This 16% appears to have characteristics which suggest they are more vulnerable than the wider population:

- 30% earn less than £300 a week (compared to the population average of 20%).
- 80% have access to the internet at home (compared to the population average of 93%).
- 74% cannot afford to make savings of £10 or more a week (compared to the population average of 32%).

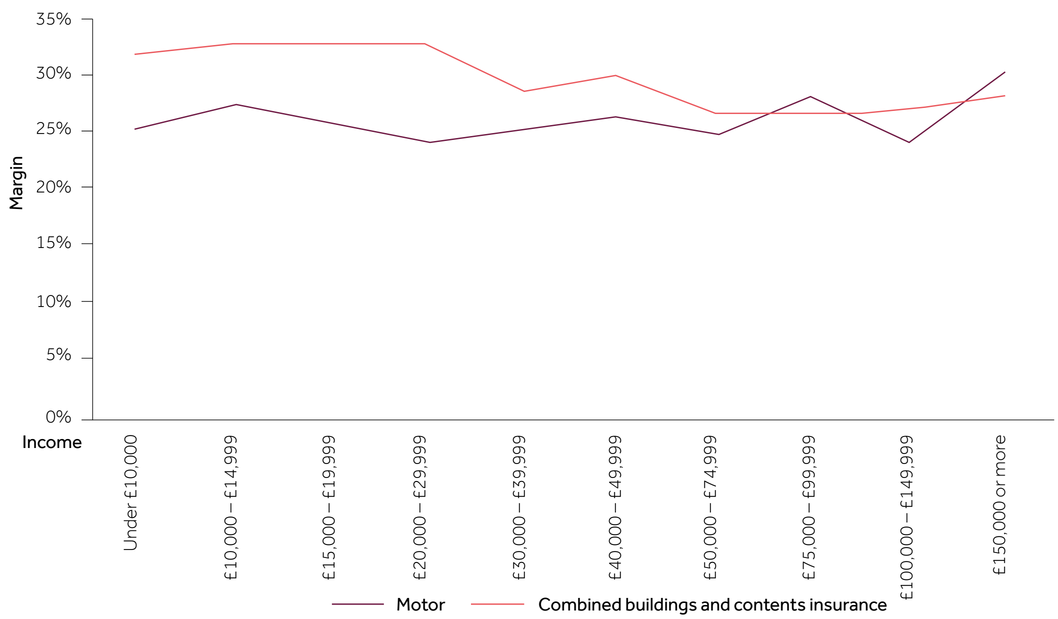
**5.55** For cash-strapped households, funds for contents insurance may be competing with spend on housing, food, heating and electricity.

**5.56** There is not similar data for motor and other types of home insurance customers that would allow us to understand why individuals become uninsured.

**5.57** We use income as a substitute for affordability and compared this to the margin paid. We know that the overall price affects consumers' access, especially for consumers living in high risk areas, and that price discrimination is only one driver of the overall cost of insurance. But, by comparing income to margins, we control for some of this variation. If pricing practices increased access we would expect to see those whose low incomes make them less able to afford insurance paying lower customer margins.

**5.58** Our results show no evidence that current pricing practices are increasing access to insurance for consumers with low income (see Figure 14 below). In fact, for combined home insurance, lower income consumers (below £30k) pay higher margins than those with higher incomes. (We do not have a large enough sample size to run this analysis for contents or buildings only insurance.)

***Figure 14: Relationship between income and margin paid for insurance***




Source: FCA analysis of consumer survey and policy data

**5.59** We also looked at how price changes would affect access. Our consumer survey found that if there was a significant increase (50%) in the renewal price, 1% and 3% of customers in the motor and home insurance market respectively might drop out of the market instead of shopping around. So current pricing practices may restrict access if prices rise significantly at renewal but this effect is relatively small.

5.60 We are concerned that vulnerable consumers may be unable to benefit from lower margin products and may be more likely to drop out if their premiums rose. In our consumer research, we found that potentially vulnerable respondents were less likely to shop around and switch (see the Consumer research – narrative report for more details). We also found that consumers who are vulnerable in two or more characteristics are more likely than average to be unaware. In home, we identified 68% of these vulnerable consumers as likely to be unaware of current pricing practices (compared to the average of 57%). In motor, we identified 64% of these vulnerable consumers as likely to be unaware of current pricing practices (compared to the average of 57%).

## Assessment of whether pricing practices create barriers to entry, change and innovation

5.61 Finally, we considered whether the current form of price competition leads to barriers to entry or expansion, including barriers to innovation or different pricing practices.

5.62 There are challenges to new firms entering the home and motor insurance market, such as the level of capital required. Yet, there is evidence of entry from intermediaries, and the development of new and innovative propositions. This demonstrates that firms can overcome these barriers.

5.63 Most firms in the market have similar strategies, where they offer low prices to new customers and increase prices for existing consumers over time. New entrants told us that instead of innovating on pricing, they are focused on regaining the trust of consumers in insurance products by being more transparent as to why prices change, which may apply pressure to firms engaging in price discrimination. This indicates that the current nature of competition in the home and motor insurance markets may be a barrier to innovation.

5.64 We see some new business models emerging for home and motor insurance. For example, research carried out for this market study by Deloitte, suggests that there is a growing trend in usage-based and on-demand insurance. These trends could bring positive benefits. For example, they may encourage more consumers to get insurance by offering consumers flexibility to pay for insurance only when needed. Auto-switching has the potential to help consumers who might not otherwise shop around but could benefit most from doing so.

5.65 We are mindful that increasing amounts of consumer data are becoming available. This could be beneficial if consumers choose to share it with providers who could help them shop around and switch to better deals.[5] It may also allow more accurate pricing for individuals. However, it could also widen price differentials between consumers who actively shop around and switch, and those who do not. It is important that firms have strong governance and controls in place to ensure good outcomes for customers given the increasing use of consumer data in general insurance markets.

5 Please see the Deloitte report on future of general insurance pricing for more information regarding key business model innovations.

## Conclusion

**5.66** There is strong price competition for new business in both the home and motor insurance markets. This is facilitated by firms' price discriminating between new and renewal customers. Further, we saw evidence that ancillary income is a key contributor to overall profitability for both insurers and intermediaries.

**5.67** We find that competition is not working effectively or efficiently in the interest of all consumers. We are concerned that firms are price discriminating based on consumer awareness. This is because:

- 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. While we find that most consumers are informed and are aware that the renewal prices offered will often be higher or not as competitive, a substantial minority of consumers are unaware. The complexity and lack of transparency about how firms are pricing makes it difficult to understand how much they might benefit through searching and switching. We are concerned that vulnerable consumers are more likely to be unaware of current pricing practices. These vulnerable consumers, therefore, may struggle to find low margin products and this could limit their access to insurance.

**5.68** We find that overall firms providing home and motor insurance are profitable, although there is no evidence that these profits are excessive.

**5.69** We also find no evidence that the form of price discrimination which is occurring is, or is likely to, increase access to insurance.

**5.70** While the home and motor markets are not highly concentrated and there do not seem to be significant barriers to entry, we find that the current nature of competition can be a barrier to firms who want to develop innovative business models. However, over time, this may be changing as firms offer different insurance products.

# 6 Outcomes from pricing practices

6.1 The previous chapters have looked at how firms set prices and treat customers, and how pricing practices impact on competition. In this chapter, we consider what consumer outcomes we see from pricing practices. We look first at the customer journey and consumer understanding of the market and outcomes for different groups of consumers. We then consider the specific pricing outcomes we see for consumers using analysis of data from firms.

6.2 In parts of this chapter, we present results of our analysis separately for three types of home insurance product – home contents only, buildings only and combined contents and buildings.

## Consumer journey and understanding

### Customer journey

6.3 In our consumer survey, Consumer research report, 81% of motor insurance respondents and 72% of home insurance respondents said they undertook 'active' forms of search. More than half the respondents (52% in home insurance and 59% in motor insurance) reported they used two or more forms of search activity.

6.4 Approximately a third (35%) of respondents in both markets reported they had switched providers. In addition, 25% of respondents in home and 31% of respondents in motor said that they contacted their insurance providers and tried to negotiate a lower price. In most cases, negotiating seemed to be effective: 60% of respondents who tried to negotiate said they achieved lower prices for the same level of cover and excess.

6.5 12% of respondents in home and 8% of respondents in motor reported they renewed automatically without doing any research. Potentially vulnerable customers, such as less financially resilient respondents and those who were not confident managing their money were more likely to auto-renew without doing any research. In home, this amounted to 23% and 25% respectively, and in motor 13% and 16% respectively.

6.6 Respondents in motor tended to be more engaged in shopping around, negotiating with their providers and switching than in the home insurance market.

### Consumers' understanding of how the market currently works

6.7 While consumers broadly appeared to understand how the market currently works, a substantial minority of respondents did not. About 90% of respondents in both markets believed that first-time customers were charged lower prices for the same product than comparable existing customers. Approximately 80% of respondents in both markets thought it was not certain that prices would remain the cheapest without shopping around. However, over a third of respondents (35% in home insurance and 31% in motor insurance) assume price rises are due to an increase in insurance costs.

6.8 Respondents who already had insurance tended to be more likely than first-time policyholders to believe that insurance providers charged new customers lower prices than comparable existing customers.

6.9 Respondents who had switched providers were also more likely than those who had renewed policies with the same provider to understand that increases in insurance prices may not be driven by rises in insurance costs.

### Consumers' attitudes to how the market works

6.10 The context affected whether respondents thought loyal customers paying higher prices was fair or not. Most survey respondents (87% of home insurance consumers) thought it was unfair for a 5-year customer to pay higher prices than a comparable new customer. However, most survey respondents (approximately 80% in both markets) thought it was also fair that people who shop around save money. On the other hand, when respondents were asked to consider consumers who couldn't shop around because they were busy with a life change (such as having a new baby), 51% of motor insurance respondents (53% of home) thought it was unfair that such a consumer should pay more.

## Consumer outcomes

6.11 We analysed the data to understand what margins consumers pay, and the size of the differentials between new and longstanding customers across all firms in our sample for home and motor.

6.12 We examined customer outcomes using data provided to us by insurers and intermediaries on the premium paid and expected claims cost for individual policies. This allowed us to assess how far premiums vary across customers for a given level of risk (ie a given expected claims cost). We used this information to create a 'customer margin' for each policy. This is measured as the difference between the premium and expected claims costs as a proportion of the premium.

6.13 This customer margin measures the contribution an individual policy makes to non-claims costs, expenses and profit. Therefore, it provides insights on competitive dynamics in the market. In general, we would expect competition to drive margins down.

### Customer margins are higher for home insurance

6.14 We found that between 2014 and 2018, average customer margins across all consumers in our data were higher for home (38% mean, 39% median) than for motor insurance (24% mean, 25% median). Historically claims costs as a proportion of premiums (the claims ratio) have been higher for motor insurance than for home insurance. The lower average customer margins for motor in our individual policy data reflect those differences. Over the same period, customer margins for home insurance have decreased slightly, and increased slightly for motor insurance over the same period.

6.15 For home insurance policies, we see different average margins depending on the type of insurance product. In our sample, we see that contents only policies have the highest average margin 57% (64% median). Buildings only policies have an average margin of 44% (47% median). Combined buildings and contents policies have the lowest average margin 30% (32% median). We have assessed each of these products separately.

## There is considerable dispersion in margins across consumers

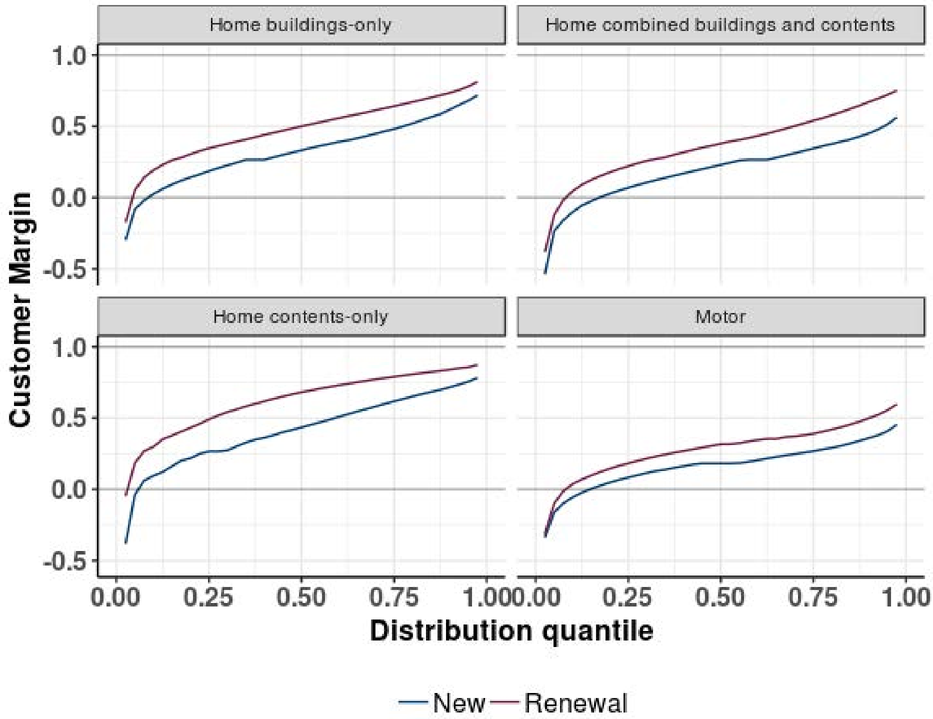
6.16 We found considerable variation in margins across customers, but it is relatively smaller for motor than it is for home (see Consumer outcomes technical annex for a detailed account of this analysis). We also found that there are a small proportion of customers whose premium does not cover the expected claims costs of the policy let alone the administration and acquisition costs associated with it (negative margin). These may be new business customers who are getting a substantial new business discount. Or they may be customers who have had a substantial increase in their expected claims cost but their premium has not yet been adjusted. In the latter case, a number of insurers highlighted that they would spread any price adjustment following an increase in expected claims costs over multiple years.

6.17 To understand in more depth the determinants of price dispersion, we looked at differences between margins for new business vs margins for renewal customers and, later, at how margins evolve over the length of time they hold the policy (tenure).

## Customer margins increase with tenure

6.18 New business customers typically pay lower premiums than a renewing customer for the equivalent expected risk. For home contents-only policies, the average margin for renewing customers is 21 percentage points higher than the average margin for new customers. For buildings-only policies the difference is 16 percentage points, while for combined buildings and contents it is 17 percentage points. For motor, the average margin for renewal policies is 11 percentage points higher than the average margin for new policies. However, as shown in Figure 15, there is substantial variation in customer margins between new customers and between renewal customers.

*Figure 15: Comparison of margin distribution at the market level for home and motor insurance*

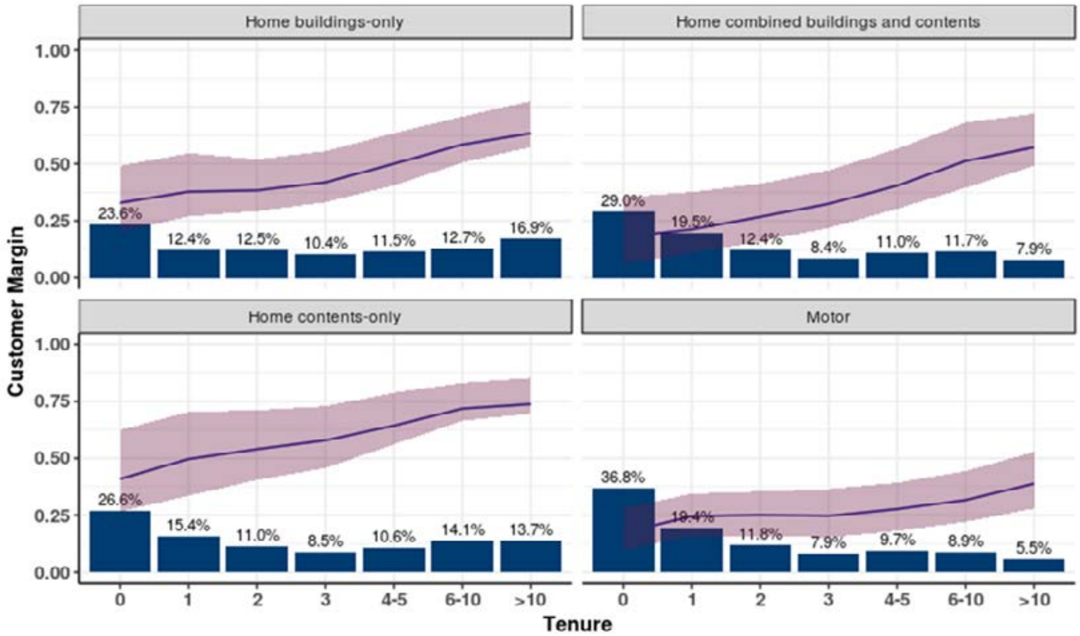



Source: FCA analysis of transaction data provided by firms

**6.19** In addition to the difference between new and renewal customers we found that, on average, consumers pay higher margins the longer they stay with the same provider. Figure 16 shows the margins firms in our data sample charged to customers in our data sample by the length of tenure, as well as the distribution of margins across tenure. This is split by the products within scope of the market study (home contents only, buildings only and combined buildings and contents insurance, and motor insurance).

**6.20** A customer's tenure is correlated with a number of other factors that may influence margins, such as age or whether they auto-renew. We have used regression analysis to control for a range of observable characteristics. This regression analysis indicates that after controlling for those factors, tenure is associated with steadily increasing customer margins. A customer that has been with their provider for more than ten years would be expected to pay a margin that is approximately 25 percentage points higher than a new business customer for motor insurance. For home insurance, it is 32 percentage points higher (35 percentage points for buildings-only, 25 percentage points for contents-only and 34 percentage points for combined buildings and contents respectively).

*Figure 16: Margins charged by firms across customers by tenure*

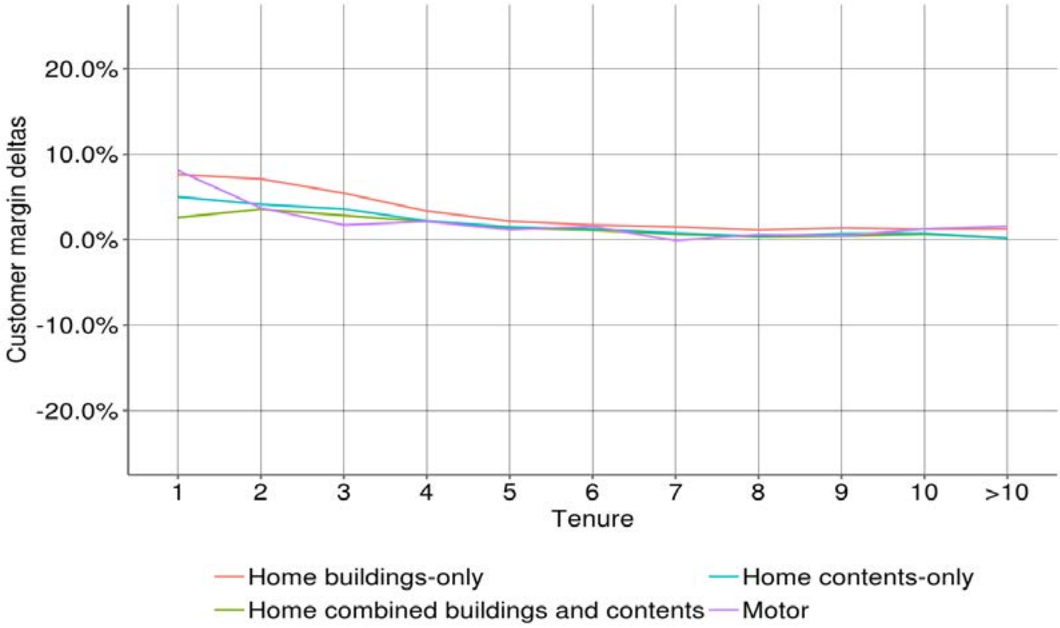



Source: FCA analysis of customer data provided by firms. The line represents the average margin at each tenure duration. The shaded area represents the interquartile range. The bars represent the proportion of policies in our sample at each tenure duration. Consumer outcomes technical annex provides more details on how the graphs are created.

**6.21** The steady upward increase in average margins we see for customers of longer tenure is driven by various factors.[6] First, a firm may increase an individual customer's price year on year. Figure 17 shows that customers on average face year on year increases in their margin for the first 5 renewals. However, these gradually reduce over time so that after 5 years increases in margin are small. Second, consumers who are charged high margins are also those more likely to renew. In both home and motor, consumers who are charged high margins are 3% more likely to renew than those not charged high margins. Third, firms can identify consumers who are more likely to renew and charge them higher premiums relative to their risk. As this happens over time, the group of longstanding customers becomes composed of more high margin customers.

6 The distribution will also be affected by the trend in average new business prices over time.

*Figure 17: Percentage points difference in customer margin between subsequent observations for the same policy, by tenure*




Source: FCA analysis of customer data provided by firms. The graph pools all observations over the 2014 to 2018 period.

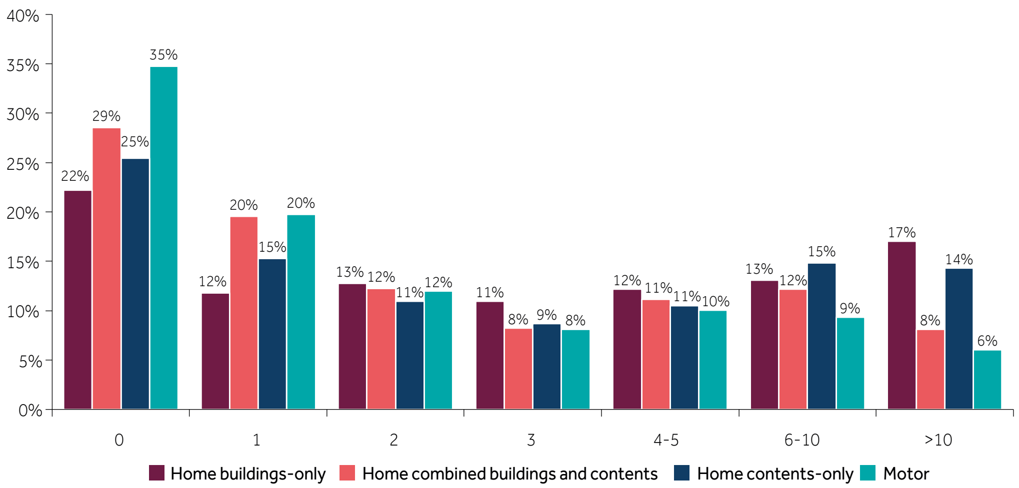
## The number and composition of longstanding customers

**6.22** To understand the implications of pricing practices for longstanding customers we have looked at the proportion of customers who have been with their insurance provider for a long period of time, their characteristics and the factors that influence their tenure.

### How many consumers fall into different lengths of tenure

**6.23** Figure 18 shows how many consumers in our data sample are new business customers (year 0) through to those who had been with the same provider for more than 10 years. We see that there is a larger proportion of customers with longer tenures for home insurance than motor insurance. Buildings-only and contents-only policies are particularly affected. This is partly accounted for by a shift over time away from separate policies to combined buildings and contents cover.

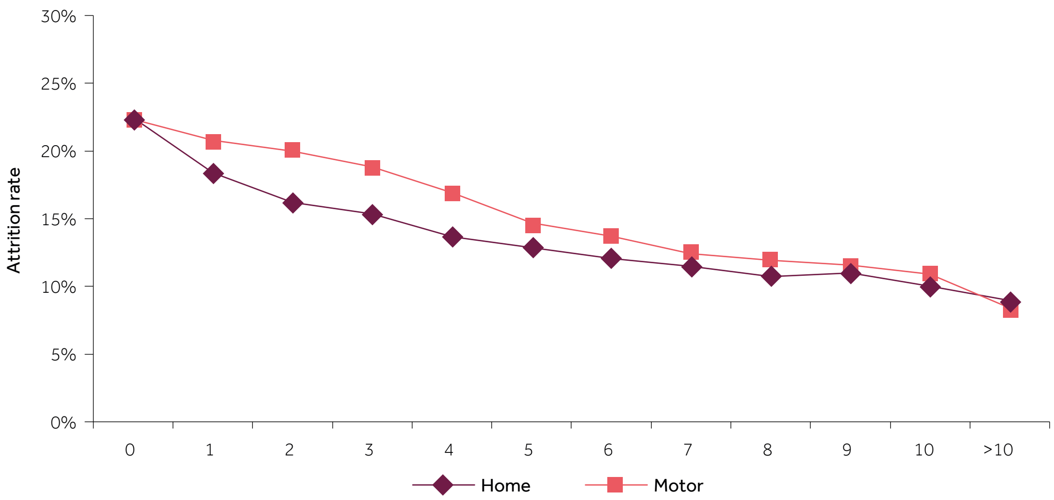
*Figure 18: Proportion of consumers in sample data for home and motor insurance by tenure (years)*




Source: FCA analysis of data provided by firms

**6.24** Tenure composition at any point in time is influenced by switching rates, the rate of new entry and trends over time in the sale of policies. We compared the proportion of customers who do not renew with their existing provider (attrition rates), across products. Attrition rates decline with tenure for all products. Consumers with longer tenure are more likely to renew with their existing provider. More than 90% of customers who have been with their provider for 10 years renew their policy. Attrition rates are slightly higher for motor policies than for home policies, particularly in years 1-5.

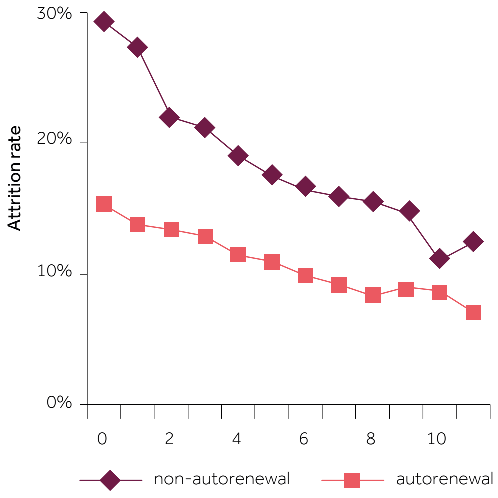
*Figure 19: Attrition rate by tenure, 2017*




Source: FCA analysis of data provided by firms

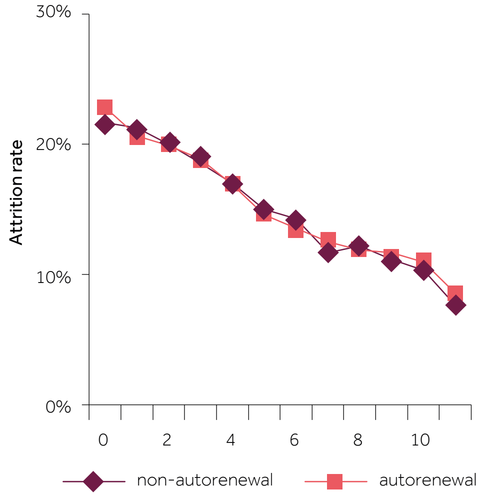
**6.25** We have also examined what determines attrition rates across different types of customers. As indicated in Figure 20, we find that those home insurance customers that do not have their policy set up to auto-renew have much higher rates of attrition than customers who auto-renew. However, we find that auto-renewal does not have an effect on attrition rates for motor insurance (Figure 21). In our sample, 59% of home policies and 68% of motor insurance policies are set to auto-renew.

***Figure 20: Attrition rate by tenure and auto-renewal, home insurance, 2017***




Source: FCA analysis of data provided by firms

***Figure 21: Attrition rate by tenure and auto-renewal, motor insurance, 2017***




Source: FCA analysis of data provided by firms

**6.26** Auto-renewal is the default option for most firms, so consumers must make a positive choice not to have their policy auto-renew. If a consumer is more active, they may be more likely to consider whether they want their policy to auto-renew. Less active consumers may be more likely to allow their policy to auto-renew without shopping around to see if there are better options.

## The scale of high margins

**6.27** What different consumers contribute to expenses and profits depends on the form of pricing a firm adopts and the consumer's tenure. With life-time value pricing models that use price walking, new customers will pay lower margins and longstanding customers higher margins. A customer paying a high margin in one year may have been given an initial discount or reduced margin in previous years. Over the lifetime of the policy a customer may pay overall an average contribution to margin. Therefore, it is important to consider this lifecycle and not just look at the margin at a snapshot in time.

**6.28** There are clearly some winners and losers, even after considering a consumer's overall lifetime contribution to the policy. Someone who switches frequently may benefit from getting repeated new business discounts. They will pay consistently low margins over a long period and so make a very small contribution to insurers' expenses and profits. These margins would not even out over the overall life time of the customer relationship.

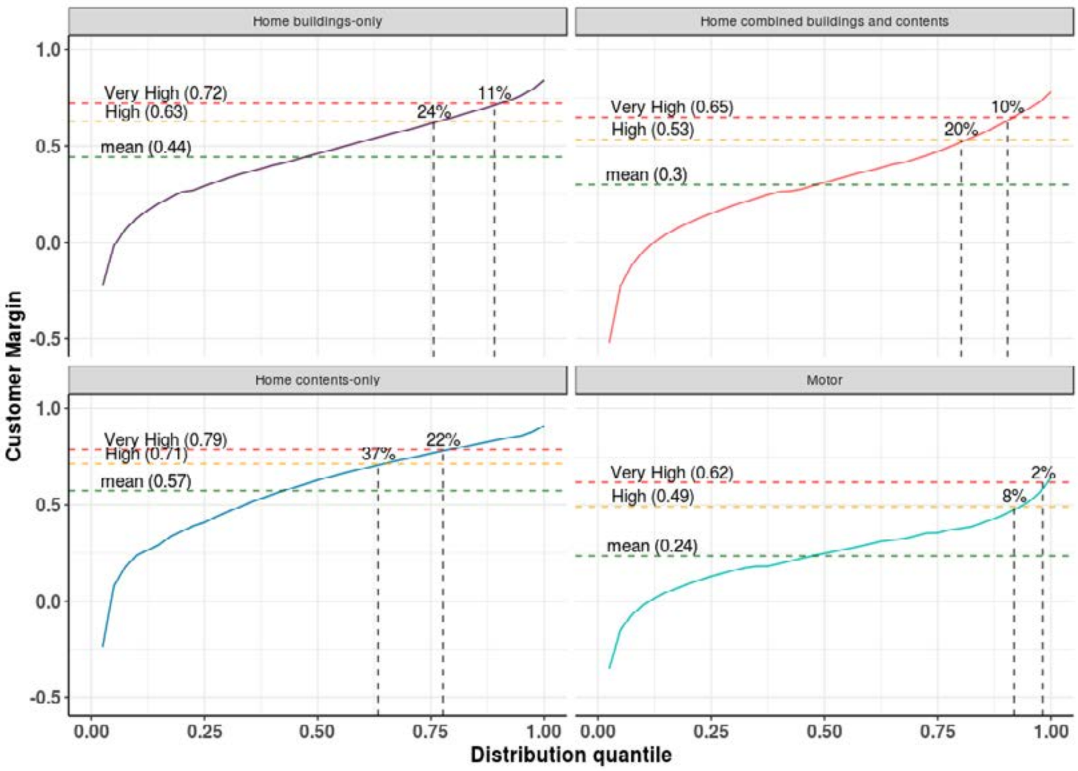
**6.29** The higher the margin and the longer the customer's tenure the more likely it is that they are making a disproportionately high contribution to expenses and profits. We are concerned if a firm's pricing model relies on a small proportion of inactive consumers covering a substantial part of a firm's nonclaims costs, expenses and profits. We examined those customer contributions to establish how many consumers were paying high margins.

6.30 We first calculated the market average margin for firms in our sample for each product. If this margin was the same for all customer policies across the market, this would cover the current market level of costs, expenses and profit. We then set thresholds that were at a premium 50% above this (we term this a 'high' margin) and double the market average premium for the risk (a 'very high' margin). These are only indicative thresholds and need to be considered in the context of any initial discount for the consumer. The typical difference between the new business margin and renewal that we observe is 19% for home and 11% for motor. Longstanding customers may have been paying high margins for several years.

## How many customers are paying high margins

6.31 The market average level of customer margins charged by firms varies between home and motor insurance. Figure 22 shows the distribution of margins across all consumers in the data we collected from firms, relative to the thresholds that we have set.

***Figure 22: Margins across consumers in home and motor insurance***




Source: FCA analysis of data provided by firms. The curves illustrate the distribution of customer margin in 2018 for each product. The horizontal lines, correspond to (from the bottom up) the market average margin, the high margin threshold and the very high margin threshold in 2018. The intersection between the distribution of customer margin and three horizontal lines, allows to identify the proportion of customers paying for policies characterised by margins at or above the threshold.

6.32 For home insurance, we estimate 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). One in 10 policy holders are paying very high margins (a premium that is double the market average for their risk). For contents-only home insurance policies, which have a larger proportion of longstanding customers, we find that more than 1 in 3 customers are paying a high margin and 1 in 5 are paying very high margins. Overall, we estimate that for all types of home insurance policies more than 4 million home insurance customers were paying high or very high margins in

2018. If those who are currently paying high or very high insurance margins instead paid average margins, the total premiums those customers pay would fall by £750m.

**6.33** The distribution of margins is flatter for motor insurance, so the proportion of customers buying policies characterised by high and very high margins is lower. We estimate that 8% of motor insurance customers are paying premiums 50% above the market average for their risk and 2% of motor insurance customers are paying more than double the market average premium for their risk. If those customers currently paying for policies with high or very high insurance margins instead paid average margins, the total price paid by those customers would fall by over £500m.

**6.34** Firms have different pricing policies and so some have flatter distributions of margins across customers and others have more unequal distributions. Similarly, some firms have higher proportions of customers with high and very high margins. At this stage, we have not completed our analysis of the proportion of non-claims costs, expenses and profits that high margin customers contribute to each firm. We aim to complete this analysis for the final report of the market study. We will then feed this analysis into our assessment of harm and potential remedies.

## Who are the consumers that pay higher margins?

**6.35** We analysed a range of consumer characteristics to understand if there were any that were common across consumers paying higher margins. To do this we used the transaction data from firms. We also combined the transaction data with our consumer survey data. This has given us detailed insights into the characteristics of those paying higher margins, and those who are not.

**6.36** The two datasets cover a range of different characteristics across consumers:

- Socio-demographic – including age, gender, postcode, region, income, employment and marital status.
- Vulnerability – In the transaction dataset we defined this based on customer postcodes and English indices of deprivation (IMD) 2015 and ONS Pen Portraits data. In the survey dataset we defined this based on questions we asked about insurance knowledge, comfort buying financial products online and socio-demographic characteristics. We also asked targeted questions in the survey against 4 drivers of actual or potential vulnerability, as set out in our recent consultation on guidance for firms on the fair treatment of vulnerable customers. These were:
  - health – health conditions or illnesses that affect someone's ability to carry out day to day tasks
  - life events – major life events such as bereavement or relationship breakdown
  - resilience – low ability to withstand financial or emotional shocks
  - capability – low knowledge of financial matters or low confidence in managing money
- Engagement with the home and motor insurance markets – for example their likelihood of negotiating or renewing with existing providers, or switching to new providers. We also looked at whether consumers were likely to auto-renew.
- Understanding of how the home and motor insurance markets work, preferences and attitudes to fairness.

6.37 We used a combination of graphical and multivariate regression analysis to test the relationship between margins and these characteristics. We give our findings from the analysis of the larger dataset first, with key findings on characteristics below.

## Tenure

6.38 As shown before, many consumers paying high and very high margins are relatively long tenure customers but there are also many that are not. Approximately a quarter of home insurance customers paying high or very high margins have been with their provider for less than 4 years. Nearly a half of motor insurance customers paying high and very high margins have been with their provider for less than 4 years. This highlights that while firms' pricing practices, such as price walking, mean tenure is one of the main determinants of customer margins, there are also many other factors that determine firms' prices. This means even new business customers can pay premiums that look high relative to their risk.

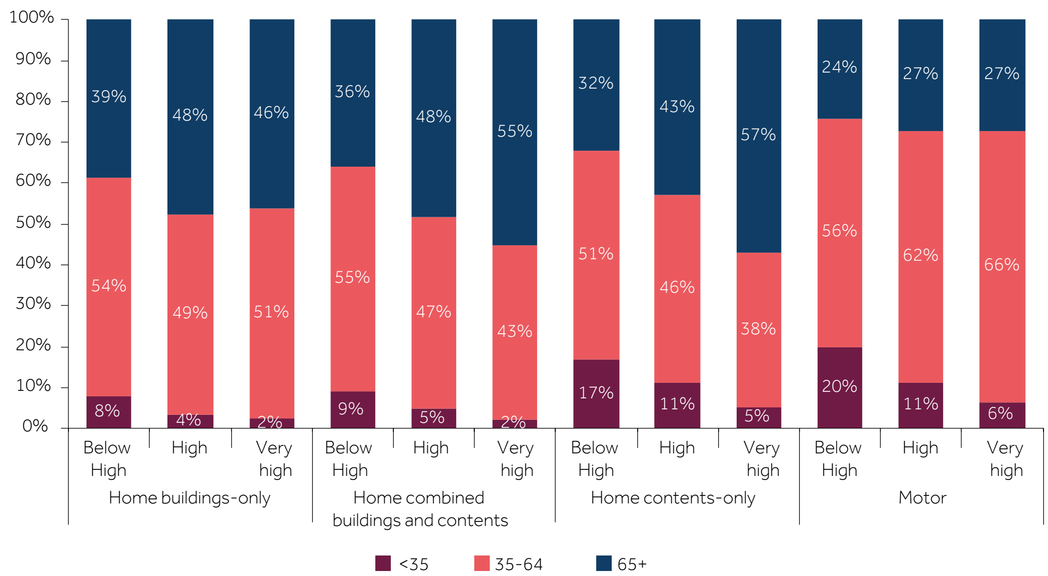
## Negotiation of price at renewal

6.39 Looking at the full data set of motor policies we collected, we saw that if a customer negotiated a discount from the firm, this led to a customer margin approximately 5 percentage points lower than previously. We did not find a similar relationship for home insurance policies.

## Age

6.40 In home, and to a lesser extent in motor, the proportion of older customers is higher for high and very high policies compared to below high ones.

***Figure 23: Age profile of consumers by level of margin, 2018***




Source: FCA analysis of data provided by firms

6.41 The relationship between age and higher margins is mostly driven by tenure. Newer customers are generally younger than those of longer tenure. After controlling for the fact that older customers have longer tenure, we did not find consistent evidence that they tended to pay higher margins than younger customers. For motor insurance, there are signs that younger drivers might be paying higher margins.

## Auto-renewal

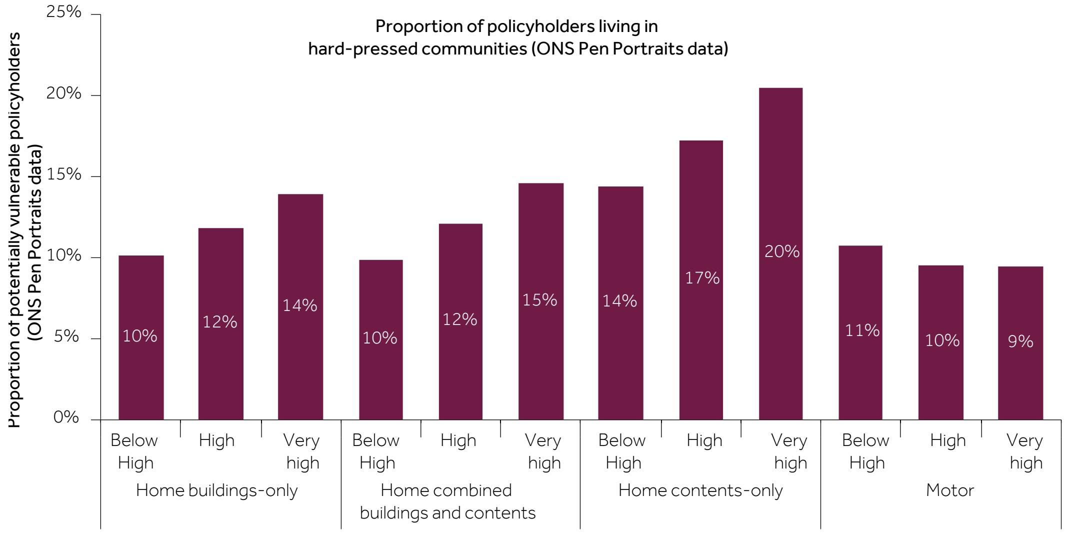
6.42 For home insurance, auto-renewing customers pay higher margins than customers whose policy is not set up to auto-renew. We found no such relationship for motor insurance.

## Vulnerability

6.43 Our recent consultation on fair treatment of vulnerable customers defined a vulnerable consumer as 'someone who, due to their personal circumstances, is especially susceptible to detriment'. We have considered alternative vulnerability definitions across the range of characteristics we identify in the transaction and survey datasets.

6.44 Within the transaction dataset, we considered vulnerability using substitutes based on postcode level data, ONS Pen Portraits and the English IMD (2015). In home, we find that the proportion of customers living in postcodes classified as "Hard-pressed communities" is higher among higher margin policies.

***Figure 24: Proportion of potentially vulnerable consumers by level of margin, 2018***



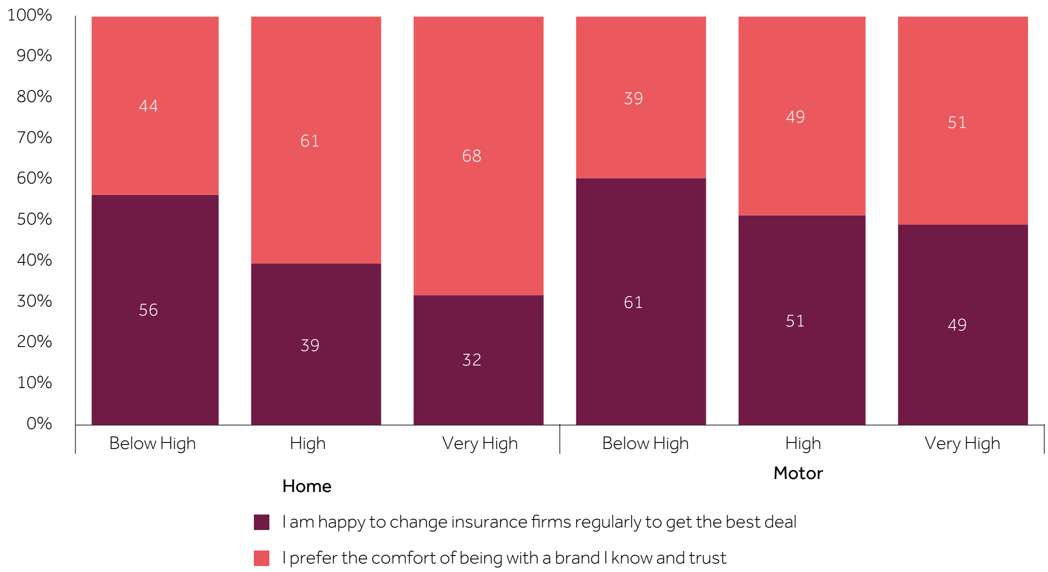

Source: FCA analysis of data provided by firms

6.45 We test this relationship in a multivariate regression and find some evidence that, in home insurance, customer margins might be slightly higher for customers identified as vulnerable, although different models give different results. So we used information from the consumer survey research to explore this issue in more detail.

6.46 Within the survey dataset, we did not find that any of the 4 drivers of vulnerability identified through targeted questions were consistently more common among high margin customers. Although there was evidence that customers with these characteristics pay higher margins on average, this could be the result of other characteristics of these customers.

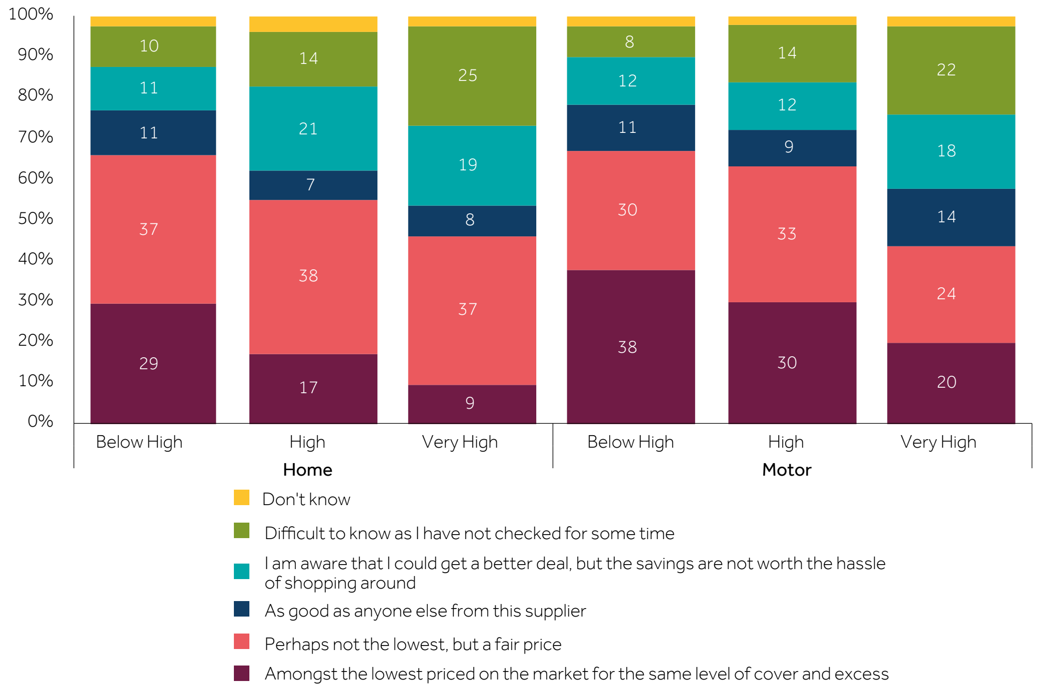
6.47 Considering a broader definition of vulnerability, the analysis suggests high margin home customers are less comfortable buying financial products online. Both home and motor high margin customers report lower levels of insurance knowledge in some cases. If low margin policies were only accessible to customers who were comfortable buying financial products online, or had relatively high self-reported knowledge about insurance products, vulnerable customers without these characteristics could be excluded from accessing low margin offers.

***Figure 25: Which statement most closely reflects your preferences?***




Source: FCA analysis of data provided by firms and consumer survey responses

***Figure 26: How good would you say your current deal is?***




Source: FCA analysis of data provided by firms and consumer survey responses

## Other characteristics of high margin consumers

**6.48** The consumer research identified several other characteristics which are consistently found amongst high margin customers (in both home and motor markets). These include:[7]

- High margin consumers have strong brand preference. Figure 25 shows that more than 60% of high margin customers for home insurance (around 50% in motor) prefer to be with a brand they trust, rather than changing regularly for the best deal. On average, home insurance customers prefer to change regularly for the best deal (54%, 59% in motor) rather than staying with a brand they trust (46%, 41% in motor).
- Lower price sensitivity. On average, around 90% of both home and motor customers who search for a new deal are motivated by price, for high margin customers this can be as low as around 70%.
- Unaware of the competitiveness of the product they own. On average, around 55% of home customers and 57% of motor customers can be classified as those who may not be aware of the competitiveness of the product they own, given current pricing practices. For high margin customers this can be as high as 69% in home and 65% in motor.
- Lower awareness of the gains from switching or the value that their deal offers. Figure 26 shows that around 20% of home and motor customers think they could get a better deal, but the savings are not worth the hassle of shopping around, or don't know how good their current deal is because they have not searched for some time. For high margin customers, this can be as high as around 45% in home and 40% in motor.
- Lower self-reported knowledge about insurance products. On average, 21% of home customers (16% in motor) feel they have relatively low levels of knowledge about insurance products. For high margin customers, this can be as high as 30% (around 20% in motor).
- High margin home customers are generally less comfortable buying financial products online. On average, 66% of home customers are very comfortable buying insurance products online. For high margin customers, this can be as low as around 45%. A higher proportion of high margin customers reported that they prefer to buy face-to-face or over the phone, or are not particularly comfortable using their online access to buy financial products online.

## Characteristics of low margin consumers

**6.49** Low margin home customers generally exhibit the opposite characteristics to those paying high margins. For example, they believe there are deals to be found and they have the time and energy to seek them out. They also have better understanding of current insurance market pricing practices and self-reported knowledge about insurance products.

7 Average values from FCA analysis of data provided by firms and consumer survey responses and therefore my not match average values reported in Consumer research report.

## Conclusion

**6.50** The previous chapter established that competition is not working effectively for all consumers. This chapter has examined the extent to which that impacts on consumer outcomes in these markets and which consumers are affected.

**6.51** We have identified that the pricing practices in these markets lead to a large number of consumers paying prices that are significantly above the market average premium for their risk. Customers who do not switch or negotiate are most likely to be impacted in this way. However, high prices are not restricted to this group, reflecting the variety and complexity of firms' pricing models. Various characteristics associated with lack of understanding, awareness or engagement in the markets are associated with high margin customers. We find that there is some evidence that potentially vulnerable consumers can pay higher prices relative to their risk for home insurance, but do not find this for motor insurance.

# 7 Potential remedies

7.1 Our interim findings indicate that competition is not working well in the home and motor insurance markets, and pricing practices are not delivering good outcomes for all consumers. This chapter summarises our concerns and sets out the options we are considering.

## What we are concerned about

7.2 Overall, our analysis raises significant concerns that these markets could work better and are not delivering good outcomes for all consumers.

7.3 Home and motor insurance are important products for consumers and play a valuable role in protecting them from risk. The current nature of competition between firms gives many consumers an opportunity to get quality insurance products at lower prices by shopping around and switching. However, this form of competition leads to those who do not switch being significantly worse off. It also creates significant costs for both firms and consumers.

7.4 In markets, the fact that some consumers pay higher prices than others is not a concern itself. However, in the home and motor insurance markets, we think that some practices firms use, which lead to them earning higher margins from some consumers, are harmful. Behavioural economics tells us that there are various behavioural biases that can make consumers prone to mistakes. We are concerned that pricing practices take advantage of consumers who are less aware of how these markets work and how good their deal is compared to others. This means they are less likely to switch or negotiate better prices, and be worse off as a result.

7.5 We are also concerned about the lack of transparency on how prices are set. Firms do not make it clear to consumers that they earn higher margins from those less likely to switch and price walk consumers over time. Firms also engage in practices that could make it more difficult for consumers to make informed decisions about whether to switch or negotiate a better deal.

7.6 Auto-renewal can give customers convenience and some protection against the consequences of being uninsured through forgetting to renew. But we also found evidence that home insurance customers who auto-renew pay, on average, higher prices. We saw that some firms make it more difficult to cancel auto-renewal than it is to opt-in to auto-renewal. Some firms' pricing models also include as a rating factor whether or not customers have policies with auto-renewal.

7.7 The future profitability of these customers drives firms to spend significant amounts on acquiring customers and price below cost to win new business. This is likely to push up the overall price of home and motor insurance. Consumers also need to invest significant time and effort into shopping around each year so they do not end up paying high prices. These are indicators that competition could work better.

7.8 Our interim view is that we need to consider further action to tackle these concerns. In helping decide whether FCA intervention is required, we have used the FCA's six evidential questions to help assess concerns about fairness in price discrimination. A summary of our assessment is in Figure 27:

***Figure 27: Analysis of evidence from market study alongside FCA evidential questions for assessing the fairness of general insurance pricing practices***

| Question | Evidence |
|---|---|
| Who is harmed? | Consumers who do not switch or negotiate better deals tend to pay more than consumers of equivalent risk and cost to serve. These consumers show less awareness of how the home and motor insurance markets work. |
| How much are these individuals harmed? | We estimate that if high and very high margins earned from consumers fell to the market average margin, the cost of premiums for these consumers would fall by £750 million for home insurance and £500 million for motor insurance. |
| How significant is the pool of people? | We estimate that firms earn high or very high margins from 4 million people in home insurance and 2 million people in motor insurance. |
| How are firms discriminating? | Firms use complex and opaque models to determine prices in ways that consumers do not understand. The fact that firms earn higher margins from customers who do not switch is not made clear to consumers. Firms also engage in practices that discourage switching and could make it difficult for consumers to make informed choices about whether to renew and acting to get better deals. |
| Is the product essential? | Motor insurance is a legal requirement and buildings insurance is usually a requirement for a mortgage and something consumers will often view as a necessity to protect their major asset. |
| Would society view the price discrimination as egregious/ socially unfair? | Concerns have been raised by stakeholders including Citizens Advice through their super-complaint to the CMA. When we asked for consumers' views on price walking in our survey we found that, whether they shop around or remain with their provider, they think price walking is wrong. Industry has acknowledged concerns about pricing practices. The Association of British Insurers and British Insurance Brokers' Association have introduced their own Guiding Principles and Action Points. |

## Our approach to considering potential remedies

7.9 It is important that general insurance markets work well for consumers. Our statutory objectives on protecting consumers, promoting competition and protecting and enhancing the integrity of the UK financial system underlie what we are aiming to achieve through this market study. We want to ensure that firms put fair value and treatment of customers at the centre of their pricing practices. We will use the full range of tools available to the FCA to achieve this and ensure a holistic approach to tackling our concerns in these markets. It is important that customers purchase good value general insurance products. Value is driven not only by price but also by the quality of the product.

7.10 In light of our findings, in the immediate term, we will continue our work to:

- ensure firms improve the governance, control and oversight of pricing practices.
- deliver the changes required from firms following implementation of the Insurance Distribution Directive.
- continue improving transparency and engagement at insurance renewal. We introduced rules to do this in 2017, and publish our evaluation of the impact of these alongside this report. The FCA's central estimate of consumer savings is £185m per year due to its intervention.

7.11 We are also considering a range of industry wide measures to reform these markets so they work well for consumers in the future. Our interim findings suggest there are three key areas that may require action:

- Pricing practices that take advantage of consumers who are less likely to switch.
- Practices that encourage consumers to renew and may discourage shopping around and switching to get better deals.
- Addressing areas of ineffective competition.

7.12 We discuss the potential remedies that could do this, and the benefits and challenges of implementing them, below.

## Remedies to tackle high prices for consumers who do not switch or negotiate better deals

7.13 We are concerned about the harm to customers who do not switch and are paying prices that are higher than those paid by customers of equivalent risk and cost to serve.

7.14 We recognise that how prices are set for home and motor insurance is complex. Any intervention that changes price setting could impact the way the industry is structured including how competition works in a market. To address the harm we have identified we are considering supply-side remedies despite these complexities.

### Restrictions on pricing practices

7.15 One potential remedy area we are considering is to limit or ban pricing practices that take advantage of consumers who do not switch or negotiate. This could be achieved in different ways including:

- Restrictions on price increases to renewing customers. For example, allowing firms to set discounts for new customers but not permit any future increases in margins beyond the first year if these customers renew. This would remove firms' ability to step prices up over time until consumers are paying prices far above costs. We could also ban price walking as a strategy for general insurance.
- Restrictions on the use of particular factors in setting prices and determining margins, for example 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.

7.16 Our comparisons of international general insurance markets general insurance markets show how issues with general insurance pricing have been tackled in other jurisdictions. Several countries have restrictions or requirements on the rating factors that insurers' can use in their pricing models. For example, in Belgium legislation was introduced in 2014 requiring insurers to be able to objectively justify the rating factors used in their underwriting and acceptance criteria for some types of general insurance. Other approaches have been adopted by states in the US. For example, in California insurers are required to use three mandatory rating factors in the pricing of motor insurance. These rating factors must have a greater impact on the premium than any of the other factors used in the pricing model.

## Helping consumers find and switch to better deals

7.17 Another option we are considering is to require firms to move consumers on to cheaper equivalent deals. Periodic automatic switching could help prevent long-term price walking. This remedy could be restricted to consumers who have renewed multiple times or who are paying high or very high prices. These consumers could be switched to the price (and level of cover) offered to an equivalent new customer with the same insurers. In considering this type of potential remedy, we are aware of the work by the Financial Services Consumer Panel on automatic upgrades.

7.18 As an alternative to automatic switching, we are also considering whether to require firms to engage with customers who have renewed the same policy consistently and who are paying high prices. This could prompt consumers to consider other options. It could also lead firms to identify consumers who they need to provide additional help to in finding and moving to better value insurance products.

7.19 Our international comparisons work revealed that switching campaigns have been used in other countries to tackle high prices for some insurance customers. For example, in Australia the consumer network 'One Big Switch' launched a campaign in 2014 to negotiate better deals on home insurance for a large group of customers that had signed up to the service. According to the consumer network, the winning offer included a 40% discount of the standard rate of a major national insurer.

## Strengthening product governance rules

7.20 We will also look at whether to strengthen or change existing rules on product governance. Our existing 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. These product governance rules apply to products manufactured, or products where there has been a 'significant adaptation', after 1 October 2018 (when the rules came into force).

7.21 We could look to expand on these requirements by:

- Applying the requirement 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.
- Including a responsibility for a senior manager to take responsibility for the value of products to the target market.

### Monitoring firms' actions to tackle concerns about pricing practices

7.22 We are also looking at ways to ensure firms are taking actions to improve their pricing practices. One option is looking at how to consistently monitor price differentials. This could include requiring firms to provide data on the average premium paid in home and motor markets across different groups of consumers. For example, firms could provide price differentials for new and renewing customers over the last 12 months. Gathering these data could assist the FCA in identifying where we need to take follow up actions with specific firms.

## Remedies to tackle practices that discourage switching

7.23 We identified practices by firms that could discourage or make it difficult for consumers to make informed decisions and act to get better deals. In some cases, firms make it more difficult for consumers to cancel contracts or stop their policy from automatically renewing. We are concerned that auto-renewal is being used in ways that could discourage some consumers from switching. We found that consumers who auto-renew for home insurance on average pay higher prices than those who do not.

7.24 These practices may not support effective competition and deliver good outcomes for consumers. We will consider action to address them. In doing so, we will be mindful of the CMA's principles for healthy competition and acceptable behaviour by firms. These were set out in the CMA's update on the response to the loyalty penalty super-complaint. These are:

- Auto-renewal must be explicitly agreed to.
- Consumers are properly notified before any renewal.
- Changes to price, the product or other important terms must have the consumer's express agreement.
- It should be at least as easy to exit a contract as it was to sign up.
- Minimum terms are restrained and no longer than justified.
- No auto-renewal onto a fresh fixed term.

7.25 We will consider the extent to which each of these principles are relevant for motor and home insurance.

7.26 Potential remedies could include:

- 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.

7.27 In developing any potential remedy, we will carefully consider the impact on the advantages of auto-renewing insurance. Auto-renewal provides benefits for some consumers. Consumers who want to renew with their insurer do not need to invest time into renewing their insurance. Auto-renewal also protects consumers who have forgotten to renew insurance from becoming uninsured. This is especially important when insurance is a legal requirement as for third party motor insurance. Our international comparisons work provides insights into how this issue has been approached in other jurisdictions. In Italy for example, automatic renewal for third party motor insurance is banned, while for most other types of general insurance, it is limited to two years. These rules have been in place since 2005 to encourage consumers to shop around and to switch provider if a better deal is available.

## Remedies to make firms be clearer and more transparent in their dealings with consumers

**7.28** The consumers who do not switch and are paying the highest prices for their insurance are unlikely to fully understand the implications of this. The complexity and lack of transparency around how firms set prices is unlikely to help consumers make informed decisions. We see firms being clear and transparent in their dealings with all consumers as integral to well-functioning markets. We are looking at options to ensure that this is at the centre of how firms set prices for general insurance and how they treat their customers.

### Improving the way firms communicate with customers

**7.29** A significant part of ensuring transparency involves improving the way that firms communicate with customers to ensure they help consumers make informed decisions about whether to renew. This could include requiring firms to make clear to consumers that renewal prices have increased because they have not switched for a number of years. It could also include requirements for firms not to use statements that could discourage consumers from switching.

**7.30** Where we have previously found that consumers did not have all the information required to make decisions we have required firms to provide additional information to consumers. This type of remedy may not help all consumers, for example those who have more limited financial capability or face high barriers to switching. We therefore do not see providing additional information to consumers as the only solution to the concerns we have identified in this market study. However, ensuring firms are clear and transparent with consumers is likely to reinforce and support our overall package of remedies.

### Increasing public scrutiny of firms pricing practices

**7.31** We will also 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 firms, prompting them to lower prices. It may also prompt consumers to consider the prices they are charged, 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

7.32 We will also look at ways that general insurance markets could be positively impacted by technological developments and innovation in the future. Developments such as Open Finance and 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, consumers need to actively provide their data to benefit fully from these services.

7.33 We believe Open Finance has the potential to revolutionise the way financial markets work for consumers, delivering significant consumer benefits, improving competition within financial services sectors and spurring greater innovation. For example, it could make the process of finding better deals and moving to other providers easier and quicker. In the longer term, this process could be automated. Open Finance could result in consumers receiving bespoke deals based on their financial habits, which are better suited to their needs. We recognise it could take some time for the potential of Open Finance to be fully realised, and will depend on consumers engaging with it.

7.34 We want general insurance markets to be part of these transformations to ensure they work well for the future. In July 2019, we set up an advisory group to take forward our future strategy on Open Finance. General insurance is being considered as part of this work. The advisory group consists of industry experts, consumer and business representatives, as well as academics and government departments. It will inform our Call for Input on our strategy towards Open Finance which will be published later this year.

## Remedies we do not propose to focus on

7.35 There are a range of options for tackling harm we have identified. Those we are focusing on are set out above. There are some options we do not currently propose to focus on in the next phase of our work. This is because we have not seen strong evidence that they will be as or more effective in addressing harm than the remedies set out above.

7.36 We are not proposing to focus further on:

- Requiring multi-year contracts. We considered whether requiring contracts for general insurance to be longer than a one year period for all consumers could improve outcomes. Our analysis shows that consumers who pay higher prices tend to be those who do not switch provider, we do not think it is likely that increasing contract lengths will address this issue. Our international comparisons work highlights that in some countries multi-year contracts raised concerns about limiting consumers' flexibility to switch and posing barriers to entry for new firms. Some firms told us they had offered multi-year contracts to consumers but demand was limited.
- Requiring a single switching and renewal period for all consumers. We considered whether requiring this could increase engagement and motivation to switch. Similar approaches have been used in other countries. In Hungary, for example, prior to 2014 there was a statutory campaign period of one week. Firms were only allowed to change prices during that period. There was generally intense press and information campaigns to focus consumers' attention and raise awareness

to switch during that week. This statutory campaign period was removed in 2014, and it was found that this led consumers to be less motivated to switch. While this suggests that a single switching and renewal period can increase consumer engagement and switching, we do not think it is likely to address the core harm we have found where consumers who are less likely to switch pay higher prices. Further, our consumer research suggests that switching rates for home and motor insurance are already higher than in many other financial services markets, but this is not benefiting consumers who do not switch.

## Our remedies will fit with wider regulatory efforts to improve consumer outcomes

**7.37** Any remedies that may emerge from this market study will sit within the broader regulatory context of our other work to ensure general insurance products deliver value to consumers. More detail on this work is set out below.

### The Insurance Distribution Directive (IDD)

**7.38** The IDD was implemented in the UK on 1 October 2018. It introduced new requirements for insurers and insurance intermediaries distributing insurance. These rules place new focus on firms to act honestly, fairly and professionally in the best interests of customers, together with the introduction of new rules for firms in relation to product approval and oversight. Overall, these new rules support our work and should help lead to a situation where customers purchase insurance products which they need and provide good value.

**7.39** When we implemented the IDD, we introduced several changes to our rules both to transpose the directive requirements and to extend the application of/add to these. Our rules require:

- product oversight and governance arrangements –
  - All firms that manufacture insurance products (e.g. have a role in creating, developing, designing and/or underwriting) must meet the product governance and oversight requirements. This sets various high-level obligations including that the design of insurance products:
    - takes into account the objectives, interests and characteristics of customers;
    - does not adversely affect customers;
    - prevents or mitigates customer detriment;
    - supports a proper management of conflicts of interest.
  - As part of this, firms must identify the target market and ensure the product is compatible with the needs, characteristics and objectives of customers in that target market.
  - The rules also place responsibilities on distributers to understand the products being sold and the target market of customers.
  - The rules require product manufacturers to consider the charging structure for each insurance product, including examination of whether the costs and charges of the product are compatible with the needs, objectives and characteristics of the target market. We believe that value is an important consideration for firms when manufacturing products, determining distribution strategies and setting their remuneration structures. We have consulted on

guidance for manufacturers and distributors of non-investment insurance products (GC19-02). This guidance consultation sets out our view of how firms should consider value when complying with the requirements on the manufacture and distribution of insurance products. We intend to publish our response to the consultation later in 2019, and our response will be informed by work on this study to date.

- the customer's best interests rule –
  - We have always expected firms to do what is right for their customers, and have set out clear rules in this regard – including the Principles for Business.
  - The IDD includes a rule which requires that all firms act honestly, fairly and professionally in the customers' best interests, which we implemented in our Insurance Conduct of Business Sourcebook (ICOBS) for non-investment insurance contracts. We have applied this requirement in ICOBS throughout the distribution process including when insurers effect contracts of insurance and regardless of any firm's position in the distribution chain whether or not they have direct contact with the end customer.
  - Our proposals in GC19-02 included the principle that "it is not in a customer's best interests to be offered an insurance product that does not provide value".
- insurance demands and needs –
  - Firms must obtain information to identify the customer's demands and needs. They must then consider this information alongside the products they have available to ensure that all products they then offer are consistent with those demands and needs. Firms must not offer customers products which do not meet their demands and needs.

## Dear CEO letter

7.40 Good governance over pricing outcomes for consumers should sit at the heart of firms' pricing practices. In October 2018, we issued a Dear CEO letter to firms about general insurance pricing practices. The letter set out our expectations for firms, including on governance, control and oversight of pricing practices. We have reviewed firms' responses to this letter. We note that the nature, extent and quality of responses varies widely. We have seen some examples of improved practice by some firms. However, governance of pricing practices remains an area that requires significant improvement by firms.

## Value in the distribution chain

7.41 In the general insurance market, distribution chains can involve several firms, each of which will usually be remunerated for their work. We carried out a thematic review of the general insurance distribution chains in relation to travel, tradesman and GAP/motor ancillary insurance. This found that, while we did see good practice in some firms, in other cases it was not clear that firms (both insurers and intermediaries) had considered the impact of their actions on the value of the products provided and customer outcomes. Our concerns are therefore similar to those in the market study, with some firms not considering the value of their product for customers. For example, some consumers pay high prices, which appear significantly higher than the production and delivery costs, due to high levels of commission within the distribution chain. In April this year, we published the outcomes of the review together with a guidance consultation. The guidance on which we consulted provides clarity to firms about our expectations, in particular on how we consider firms should take account of the value that the product and distribution arrangements present to consumers.

We are currently reviewing feedback to the consultation with a view to finalising it in the coming months. The guidance, when finalised, will be the first step in addressing issues, by setting out our expectations of how firms should consider value for the customer, in advance of the remedies discussed in this paper.

## General insurance value measures

7.42 Our work on general insurance value measures reporting and publication is aimed at helping to address poor product value, and complements the wider work we have been undertaking in this market study and on value in the distribution chain. The value measures work was developed following the general insurance add-ons market study in 2014, and piloted over several years with insurers. In January 2019, we published Consultation Paper: General Insurance Value Measures reporting (CP19/8) setting out proposals for the reporting and publication of value measures data across general insurance. The proposals seek to make available information about the way products perform when customers make a claim. The value measures tell us about the quality of the product and it is important that this information is available to improve market transparency and competition and encourage firms to improve their products.

7.43 We received feedback from 36 respondents on our value measures proposals. We still consider there to be valuable benefits to introducing the key proposals in CP19/8. However, informed by the feedback, we will undertake further work to:

- Review the value measures metric definitions to explore ways to reduce the scope for inconsistent reporting and improve the helpfulness of the data to users
- Review the reporting proposals with further consideration of the benefits and any risks of publishing data for the 5 largest distribution arrangements for each insurer for each product they underwrite
- Reassess the cost estimates for the cost benefit analysis.

7.44 The reality is that achieving standardised value measures is a complex task. However, firms should be in no doubt about the continued importance we attach to this issue.

7.45 Importantly, we are keen to ensure that our work on value measures has regard to any remedies being considered by this market study. Taking a holistic approach to our consideration of interventions will assist us to deliver any remedies in a cohesive way. We will therefore review and develop the value measures proposals alongside the work on these remedies.

7.46 We expect to publish any value measures policy statement to coincide with the final report for this market study. In the interim, we are launching a 4th pilot of the publication of value measures data to help maintain the increased transparency of the pilot products.

## Other relevant FCA work

7.47 Other FCA work will also be important in developing potential remedies. In particular:

- We have evaluated the impact of rules we introduced in April 2017 to increase transparency and engagement when consumers renew general insurance products. The results of this work, published alongside this interim report, show that increases in home and motor insurance premiums at renewal are estimated to be lower than without our intervention. There is a notable increase in the proportion of consumers shopping around and getting alternative quotes before renewing with their existing provider. However, our intervention has not had the scale of impact on switching and negotiating that was expected when we implemented the rules.

- We published a feedback statement on fair pricing in financial services in July 2019. This set out the framework that the FCA will use to assess concerns about the fairness of a given form of price discrimination. The first application of this framework is in this market study. We have used the framework as one tool to inform our analysis. The FCA is also doing further work to embed fair pricing into our regulatory approach. We are incorporating this into the review of our principles, which is the first strand of our Handbook Review. We intend to publish a discussion paper on the review of principles in Q4 2019/20. We will report back on the next phase of our fair pricing work at that time.
- We have consulted on guidance for firms on the fair treatment of vulnerable customers. The draft guidance sets out the FCA view on what our Principles for Business require of firms to treat vulnerable customers fairly, and ensure consistency of outcomes across sectors. The consultation period has closed and the feedback will inform this market study.

# 8 Next steps

8.1 We invite interested parties to provide views on our interim findings and the potential remedies we are considering.

## Questions on which we welcome views

8.2 This report sets out our interim findings, and the potential remedies we are focusing on in the next phase of work. We would welcome stakeholder feedback on the following questions:

**Q1:** **Do you have views on the interim findings set out in this report?**

**Q2:** **Do you have views on the potential remedies we propose to focus on? What are the potential benefits, challenges and unintended consequences that may arise from these?**

**Q3:** **Do you have views on the potential remedies that we propose not to focus on? What are the potential benefits, challenges and unintended consequences that may arise from these?**

**Q4:** **Do you think there are other remedies that we should be considering? If so, what remedies and how do you think they would address the harm we have identified?**

**Q5:** **Are you aware of potential changes or innovations in the home and motor insurance markets that may address the harm we have identified? If so, what are these and how will they address the harm and are there any potential unintended consequences?**

## How to respond to us

**8.3** Please send your views on these to GIPricingPractices@fca.org.uk by 15 November 2019. We will take these views into account in our final market study report.

## What we will do next

**8.4** We plan to conduct further analysis of the issues highlighted in this report to inform our final market study report. In particular, we will look further at:

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

**8.5** We aim to publish our final market study report, alongside a consultation paper on any proposed remedies, in Q1 2020.

We have developed this work in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

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Pub ref: 006113

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