Financial System Inquiry

Further submission by

Allianz Australia Ltd

Introduction

Allianz Australia Ltd (Allianz) welcomes the opportunity to make a submission on the Financial System Inquiry's Interim Report. Allianz's submission focusses on the issue of "aggregator access to information" that is raised in the FSI's report, specifically, the report's following statement:

> *"The main issue submissions raise in relation to insurance sector competition relates to aggregator access to information. Insurers in the home and contents and car insurance markets have been reluctant to share their product information with aggregators, slowing their growth. As a result, consumers in these markets must compare products without the assistance of aggregators, which may reduce price competition."*

While the FSI statement above refers to "product information", Allianz assumes that what is really, or specifically, meant is price information. Detailed product information on insurers' policies is freely available in hard or soft copy from insurers, in particular, Product Disclosure Statements that provide all the information (and more) any aggregator is likely to be interested in can be downloaded from insurers' internet sites.

What are aggregators?

Aggregators (also referred to as 'price comparison websites') operated by private, for-profit entities use internet sites to 'aggregate' price and/or other product information from a number of suppliers of a good or service. The main claimed advantages of aggregators are that they reduce consumer search costs and encourage price competition between suppliers. In Allianz's experience, aggregators generally obtain pricing/product information and earn revenue through one or the other, or some combination of, the following structures:

- Pricing and product information is obtained from sources other than the product seller (eg the public domain, aggregators' own pricing research or third-party providers of pricing information). The aggregator earns revenue from selling advertising space on the site to companies (whose products may or may not be being ‘aggregated’ on the site) that want to promote their products to consumers that use the site and/or by charging users a fee to obtain the information they have collected. An Australian example of this sort of site is canstar.com.au; or

- Product providers make product and pricing information available to the aggregator and are charged a fee, usually, for each product sold. Charges can be in the form of a flat dollar fee per sale or, more commonly, an ad valorem commission. For example, insurance aggregators of this sort in the Australian market charge up to 100% of the first year’s premium on each insurance policy sold[1], which for an average home or motor insurance policy could be up to $1,000 or more. An Australian example of such an aggregator is iselect.com.au, which Choice reported earned an average revenue per sale of $742 for health and car insurance in 2012[2].

Do aggregators for home and car insurance exist in Australia?

Allianz disagrees with the FSI’s conclusion that “consumers in these markets must compare products without the assistance of aggregators”. In fact, a range of aggregators representing both the models described above, and which provide collated product and/or price information from some providers of home and/or car insurance, exist in Australia. Some of these include:

- canstar.com.au;
- ratecity.com.au;
- iselect.com.au;
- comparethemarket.com.au;
- choosi.com.au
- quotesonline.com.au;
- greatchoice.com.au;
- infochoice.com.au;
- bestdealinsurance.com.au;
- claimscomparison.com; and
- captaincompare.com.au.

[1] Choice reported that choosi’s commission on the first year of premium for insurance sold through its site ranged from 15-100%. See - http://www.choice.com.au/reviews-and-tests/money/insurance/personal/insurance-comparison-sites/page/choosi.aspx, Accessed 23 August 2014.
[2] http://www.choice.com.au/reviews-and-tests/money/insurance/personal/insurance-comparison-sites/page/iselect.aspx, Accessed 23 August 2014.

Reducing consumer search time is often identified as one of the main advantages of aggregators. However, technological and other developments are increasingly achieving this objective through alternative means and supplanting the role of aggregators. Somewhat ironically, aggregators are being made increasingly redundant as a result of further technological advancements. For example, Google is effectively an aggregator for most goods or services. If you type ‘car insurance’ into Google, between paid and organic search responses, the brands for thirteen car insurance underwriters or distributers (as well as a few of the aggregators listed above) will appear on the first page. Many of these insurers provide and/or advertise the ability to get a “quote in just 2 mins” or something similar and/or discounts for purchasing online of up to 20%. Thus, in around 10 minutes, a consumer could obtain quotes from up to five motor insurers.

Moreover, insurers are moving rapidly to take advantage of consumers’ growing preference to purchase products, including insurance, on smartphones. For example, cognisant that consumers do not wish to answer long question sets on their phone, insurers are reducing the number of questions required to price a risk. As a result, quote times are being further reduced by pre-populating answers using information from third-party databases and other information sources, and the use of more sophisticated risk estimation techniques.

Should the government intervene in the market to assist the growth and profitability of aggregators?

Given that home and car insurance aggregators do exist in Australia, the FSI’s main concern appears to be that they are not growing fast enough and, hence, are not as commercially successful as they ‘should’ be. This, according to the FSI report, is because insurers are “slowing their growth” due to a reluctance to actively assist what are effectively direct competitors to insurers themselves in the distribution of their products, as well as competitors to other insurance intermediaries (eg insurance brokers, financial institutions and motor dealers) that insurers use to distribute their products.

To address the FSI’s apparent concern with the commercial success of home and car insurance aggregators, the report suggests that:

> “*One option to enhance aggregator access to general insurance product information is to ensure aggregators are able to use automated processes to seek quotes from general insurance websites.”*

In other words, the FSI report suggests that the government could intervene in the insurance market to “ensure” that insurers provide automated pricing information to aggregators in order to assist them in their commercial objective to interdict themselves between insurers and their customers and, presumably, require the insurer to pay aggregators for the privilege. Given that commissions commonly charged by aggregators (see above) are up to 10 times the cost of some alternative acquisition methods and up to 500% higher than average policy acquisition costs, forcing insurers to participate on aggregators would ultimately result in upward pressure on premiums due to the inevitable increase in average acquisition costs.

The FSI report proposes that insurers allow aggregators access to their product information and pricing systems so that they can "use automated processes to seek quotes from general insurance websites." However, insurers' websites do not 'contain' pricing information. When customers enter information into an insurer's website in order to obtain a quote, this information is transmitted in real-time to insurers' information technology systems where pricing 'engines' use risk information and other data, in conjunction with the insurers broader pricing 'intellect', to calculate the applicable premium. The premium information is then transmitted back to the insurer's website where it is made visible to the customer.

In Allianz's view, the notion that a government would intervene to force an insurer to effectively provide unrelated commercial (or non-profit or government) entities, and through them all the insurer's competitors, access to its risk databases, rating structure and, consequently, its complete pricing intellect is a radical one in the context of a market economy underpinned by property rights. If nothing else, significant costs would be incurred to establish and maintain the ability for third-parties to interconnect with and extract pricing information from insurers' IT systems.

The impact on insurers of mandatory participation in aggregators will be significantly exacerbated if, as is common for many other products where they are used, the insurer is required to give the aggregator the ability to complete the sale or, as insurers would say, 'bind' the policy. Much of the discussion in the submission does not delve deeply into the additional complexities that this would create. Below, however, just a few of the regulatory-related questions opened up by this issue are briefly outlined. For example:

- If insurers were forced to authorise the aggregator to bind insurance on its behalf, it would be required to appoint the aggregator as its agent and, unless the aggregator had an Australian Financial Services Licence, it's Authorised Representative. As such, the insurer would become responsible for the aggregator's compliance with financial services laws and for breaches of other laws, such as misleading and deceptive conduct, but with no ability to terminate the arrangement in the event that the risks of breach were considered too great. This would be a totally unworkable situation.

- If insurers were not forced to authorise the aggregator to bind insurance on its behalf, what rules would apply to the aggregator's use of insurer pricing information. Would the aggregator, for instance, be bound to provide its customers with quotes from all insurers (ie those that it had authority to bind cover for and those that it did not), or would it be free to present only some quotes, which might result in customers being selectively steered towards those insurers for which the aggregator does have an authority to bind. Or, as is the case with some existing home and car insurance aggregators, could customers be steered to insurers with which the aggregator has ownership links. If aggregators only derived income from the placement of cover with insurers for which they have been authorised, there would be a strong incentive for them not to publish lower quotes from insurers for which they had not been authorised.

Allianz suggests that, in order to recommend the mandatory participation of insurers on aggregator sites, the FSI would need to identify a significant market failure in order to justify such a costly and invasive form of regulatory intervention in the insurance market. This would include evidence that no other less interventionist alternatives are available that would be capable of addressing the perceived adverse outcomes of any identified market failure, as well as evidence that the overall benefits of any such intervention outweighed the costs.

Does a market failure exist? Are there less interventionist alternatives?

The sum total of the FSI report's market failure analysis appears to be the assertion that the 'slow growth' of aggregators means that consumers "must compare products without the assistance of aggregators" and that this "may reduce price competition". Yet, the report provides no evidence to support any of these assertions, either in respect of general insurance products or more generally, given that the logical extension of the report's contention is that price competition may be reduced in any market where aggregators do not exist. A further extension of this argument is that price competition in all markets was constrained and/or limited before the development of the internet.

Despite (or because of) the lack of any evidence of a market failure to support its suggestion for radical regulatory intervention, the FSI embarks on a search for alternatives. In this regard, the report states that:

> *"Another option could be to develop representative consumer categories based on key consumer characteristics. Insurers could disclose their policy premia for each category and consumers could then, potentially with the assistance of aggregator services, compare premiums from different insurers for the category that best represents their characteristics."*

There is nothing preventing an existing aggregator or other entity from establishing an insurance price comparison site based on 'representative consumer categories' as outlined above, even without the support of any, or any particular, insurer(s). Research companies exist that collect and sell insurance pricing information (derived from internet quotes), which can be obtained by any interested party (for a fee) and used to compile categories based on virtually any premium-relevant characteristic (eg geographic location, sum insured, property characteristics (eg of a house or car)). Indeed, many insurers purchase this sort of information so they can monitor competitor pricing to assist them in ensuring that they remain competitive in particular market segments (or at least so they are aware of those segments in which they are less competitive).

Thus, no government intervention is required in order for this alternative option identified by the FSI to develop. Of course, if insurers chose not to enter into some sort of commercial arrangement with such an insurance comparison business, the owner would need to identify viable revenue sources so that the business is commercially sustainable. In particular, a source of revenue other than charging the insurer that benefited from any subsequent sale up to 100% of the first year's premium or some other exorbitant amount. That said, how the business model for such an enterprise works is of little interest to Allianz, which we suggest should also be the case for the FSI and the government.

Are there potential adverse impacts from forcing insurers to allow aggregators access to their systems?

A focus on price at the expense of customers obtaining insurance that suits their needs

Aggregator sites tend to lead the consumer's purchasing decision towards an excessive focus on price. This is not a general criticism of aggregator sites for all goods and services. Indeed, in general, the whole purpose of aggregator sites is to help the consumer find where they can purchase a product for the lowest price. This works well in the case of products that are identical (eg an iPhone 5s). For such products, putting aside qualitative considerations relating to the seller (eg after-sales service), aggregators can provide a useful service in helping the consumer identify where they can purchase the product most cheaply.

Some insurance policies can be essentially, if not absolutely, identical. For example, statutory insurance products, that is, mandated insurance where policy features and benefits are prescribed by law, can be all but identical. Compulsory Third Party (CTP) insurance in NSW and Queensland, for example, is provided by private insurers in highly competitive markets. As the product is virtually identical[3], customers that shop around will sometimes switch insurers to save money. That said, as the product is all but identical, depending on the scheme's pricing

[3] Insurers sometimes seek to differentiate the product to a small degree, for example, through the provision of a relatively modest level of first-party cover.

regulation, premium differences can be very minor (eg $2, or less than 1% difference between the highest and lowest price) or, at times, non- existent. For example, in Qld, where insures are required to charge the same price to all owners of the same vehicle class, regardless of their accident risk profile, there has been various times when all insurers have priced at the government-regulated ‘ceiling’ for some or all classes of vehicle.

Therefore, in an insurance market where products are effectively identical, aggregators may play a role in helping consumers find the cheapest price. However, in insurance markets where there are significant differences between products, an excessive focus on price can result in customers ignoring critical policy differences, which may result in them receiving very different or unexpected outcomes compared to other policyholders when it comes to making a claim. Indeed, a homeowner with the ‘wrong’ policy may find they have no cover at all for an event that totally destroys their property and everything in it (eg the owner of a flood prone property that takes out a policy that excludes cover for flood).

The FSI report itself highlighted problems relating to the current disclosure regime, in particular, the prevalence of “long and complex” documents. Allianz agrees that, in the case of Product Disclosure Statements (PDS) for general insurance products, improvements in relation to disclosure may be desirable. For example, a short-form PDS (eg 4-6 pages) could provide key policy information in a more accessible but still informative form.

That said, Allianz also strongly agrees with the FSI report’s statement that:

> *“..attempts to make disclosure documents shorter risk the information becoming oversimplified or generalised, which may make consumers overconfident about their understanding of a product and its risks.”*

The proposed Key Fact Sheet (KFS) regime for building and contents insurance that is currently legislated to commence in November 2014 exhibits all the shortcomings (and more) described above. For example, the overly-prescribed nature of the KFS documentation means that the KFS wording for all Allianz’s home insurance policies is virtually identical. This is despite Allianz’s two main ‘types’ of home insurance being fundamentally different in respect of a key aspect of cover, that is, whether cover is provided for ‘Defined Events’ or ‘Accidental Damage’. The latter has a much broader scope in that cover is not limited to damage caused by specific defined events (eg fire, storm, earthquake). As a result, the premium for an accidental damage policy is materially higher (circa 30%) than for defined events cover, yet the relevant KFSs provide no information that distinguishes the two policy types and, hence, does not inform the consumer about the different policy features and benefits that underpin the premium difference.

Allianz is of the view that the excessive focus on price that would result from a widespread use of aggregators by consumers to purchase, particularly, home insurance, would only exacerbate the existing challenges insurers have in providing customers with the information they need to fully appreciate the differences between insurance policies and to help ensure that they end up with insurance cover that best suits their needs and expectations.

Aggregators would no doubt try and address this issue by providing some product information in addition to the price so that consumers can consider some of the qualitative differences between an insurer's different policies and between the policies of different insurers. However, Allianz has no faith in the ability of an unrelated third-party to choose which policy features to highlight to enable informed decision-making by consumers or help them make like-for-like non-price comparisons with the policies offered by other insurers.

These concerns are already apparent in the material provided by some existing aggregators. For example, in a summary of the policy features of Allianz's SureCover Home Insurance on the Canstar website, under a section headed 'Water Damage' and against the term 'Coverage for flash flooding', Canstar has a ○ symbol (as opposed to a green tick or a red cross)[4]. Putting aside the absence of a legend that indicates to customers what this symbol means, Allianz has no idea what sort of water damage the term 'flash flooding' is meant to describe. This is not a term used by Allianz and it does not appear in the Product Disclosure Statement for our SureCover Home Insurance product.

Thus, even among the home insurance aggregators that currently exist, Allianz has concerns about the information being provided about our policies. Such 'information', when combined with a price, is unlikely to make the consumer's task any easier. For example, what claim excess[5] underpins the price, given that increasing or decreasing the excess can have a material impact on the premium? Will it be the insurer's default excess, which may differ from insurer to insurer? In other words, the aggregator may provide a price ranking that would be incorrect unless all the quotes being obtained were based on the same primary excess (and the same alternative excesses if they exist – see footnote 5).

Should the use of aggregators grow over time (even without regulatory assistance from government), which is probably more likely than not, the concerns outlined above may very well become more apparent. If this occurs, governments may in the future need to consider if they should respond in some way. The current question for the FSI, however, is: should it recommend that the government intervene in the insurance market to mandate that insurers participate on aggregators?

[4] http://www.canstar.com.au/widgets/details?collection=ws_hci_fs&prod_id=1251627&profile=Building Only, Accessed 27 August 2014.

[5] Or claim 'excesses', as there may be different excesses for different 'types' of claim, for example, under a motor policy, the excess may vary depending on the age of the driver that had an at-fault vehicle accident.

In light of the potential adverse impacts on consumers' ability to make well-informed insurance purchase decisions when using aggregators, for example, due to:

- an over-emphasis on price in their decision-making,
- because the aggregator has provided consumers with deceivingly comparable or non-comparable price information, or
- due to poor or inadequate non-price information about policy features and benefits presented to them by the aggregator,

Allianz suggest that government intervention to force insurers to participate on aggregators is undesirable and, indeed, unlikely to be in the best interests of consumers.

Undermining insurers' incentives to invest and innovate

Allianz takes issue with the statement in the FSI report that the 'slow growth' of aggregators has resulted in "reduce[d] price competition". Competition in insurance markets is highly competitive, particularly home insurance. For example, home insurance portfolios have not achieved long-term target returns (or even been sustainably profitable) for most, if not all, insurers in Australia for several decades. According to Finity, in the 36 years between 1977 and 2012 (inclusive), home insurance in Australia achieved a Target Combined Ratio (of 95%) for less than 10 of those years (between 1996-98 and 2003-07) and the overall size of the losses far exceeded the meagre profits earned in the profitable years.[6]

In such a competitive environment, insurers have a strong incentive to innovate and invest in anything that enhances customer experience and loyalty, increases efficiency, reduces costs or otherwise improves profitability. In relation to profitability, a key determinant of success is an insurer's risk selection capabilities. In terms of risk selection, one of an insurer's main competitive advantages compared to its competitors is its 'pricing intellect', which is used, among other things, to set individual customer premiums with a view to them being (or becoming, after the amortisation of upfront acquisition costs) a profitable member of the insurer's risk pool.

In Allianz's view, forcing insurers to participate on aggregators would rob insurers of the intellectual property they have developed from investing in risk-related pricing research and data. This would result in a significant reduction in the incentive to invest in improvements to risk pricing technologies and capabilities and in product innovation.

[6] Finity Consulting Pty Ltd, *Insuring the Great Australian Dream, Personal Lines Pricing Seminar*, May 2014, p.22.

The FSI report recognised this, stating:

> *"If this access* [to aggregators] *was provided, it could potentially enable aggregators or other market participants to identify sensitive pricing information, such as premia differentials based on market research."*

If insurers were forced to be on aggregators, companies[7] would be able to set up 'bots' (ie automated quote generating programs) which could be used to extract detailed pricing information from an insurer. For example, such a computer program could be used to harvest multiple quotes (literally tens of thousands) from a competitor via the aggregator. Customer profiles could be established and the program designed to generate quotes based on changes to single risk factors (eg age of home owner, postcode of property, a house's security features, construction materials etc etc) in order to identify how the premium responded.

Through such activities, a company would be able to 'deconstruct' a competitor's whole pricing structure and effectively 'steal' their proprietary pricing and risk information, which may have been developed through significant investment in internal research and capabilities, or the purchase of costly analysis and data from external sources. This would reduce an insurer's incentive to invest in research and risk information because any resulting pricing intelligence could be appropriated by its competitors (or others) for relatively little cost.[8]

In particular, larger insurers, who would inevitably have greater access to the funds, resources and capabilities needed to undertake this sort of competitor pricing analysis, could use such techniques to discover 'mispricing' among, particularly smaller, competitors that have less advanced pricing capabilities. This information could then be used to aggressively target those competitors' better risks and/or 'allow' them to continue to under-price the poorer risks, hence, undermining the profitability of those competitors.[9] Over time, such competitive behaviour could force some existing insurers to raise prices to remain profitable (further reducing their competitiveness) or exit the market, hence, reducing competition.

To the extent they can, insurers currently use a wide variety of legitimate strategies to out-compete each other, such as investing in improved risk selection and pricing capabilities. While good for consumers overall, strong and healthy competition will inevitably see some weaker businesses fail, not necessarily in terms of insolvency but, for example, not growing as

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[7] For example, competitor insurers, an insurer looking to enter the market, or, indeed, the aggregator itself, which may have ownership links with an insurer (as some currently operating in Australia do) or seek to sell this information to an insurer.

[8] Allianz's website (similar to other insurers) is continually attacked by bots seeking to extract pricing and risk rating information from our IT systems. Allianz invests significantly in the resources and capabilities needed to minimise the ability for this to occur from 'unfriendly' sources. What incentive would aggregators have to invest in IT resources and capabilities to protect the pricing intellect of insurers participating on their sites?

[9] Consumers will also discover insurers' mispriced risks. The potential impact on prices of this is discussed in the following section.

fast or being as profitable as their shareholders would wish. This is a natural outcome of competitive markets and nothing consumers or governments should be concerned about. The question for the government and, in the current context, the FSI, is whether it is desirable for the government to proactively intervene in a market (eg by mandating insurer participation on aggregator websites) in a way that could increase premiums for some consumers and/or have adverse impacts on competition.

Aggregators appear to have enhanced price competition for some products, why not insurance?

Discussion of government support for insurance aggregators has arisen recently in the context of a search for solutions to the very high premiums facing some homeowners that are highly vulnerable to natural hazards, specifically, flood and cyclone. Insurance affordability for such homeowners was an issue that Allianz discussed in its first submission to the FSI. For example, the Commonwealth Treasury has released a discussion paper on the high cost of home insurance in Nth Queensland in which the issue of aggregators was raised.

An attraction to aggregators in the context of concern about insurance affordability for a small proportion of homeowners appears to stem from a view that, because aggregators appear to have resulted in aggressive price discounting for some goods and services, this will automatically be the case for all products, including home insurance. For example, aggregators are widely used in respect of airfares (eg Webjet) and hotel rooms (eg Wotif). However, these products exhibit characteristics such that it can make commercial sense to engage in aggressive price discounting in some circumstances (eg over specific time horizons).

For example, the provision of these particular services is characterised by high fixed costs and, as a result, relatively high average costs compared to marginal costs. The consumption of these products is also characterised by fixed and immovable ‘expiration’ dates. Indeed, there is a relatively short period of time during which they can be consumed and such products, therefore, can only be sold prior to their specific ‘consumption date’. For instance, it is not possible to sell a seat on a flight that has departed or a room in a hotel for last night.

For example, once departed, the cost to the airline of an occupied seat on a plane is only marginally more than the cost of an empty one. Once enough seats are sold at prices that, collectively, cover the overall ‘cost’ of the flight, so as long as the fare exceeds the marginal cost of servicing another passenger, the airline has an incentive to sell any empty seats at that relatively low price. For this reason, depending on the revenue generated from seats already sold on a flight, the number of remaining empty seats and passenger demand, at various times prior to departure, airlines have an ability to adjust prices, sometimes to levels close to marginal costs. This can result in some fares, depending on when they were purchased, being substantially lower than others for what is the same product. Similar pricing strategies can be used for hotel rooms.

Incentives to aggressively discount prices can also arise in respect of physical goods. For example, where a company has purchased a certain amount of stock, has recouped its costs and made a profit from the sale of some of it and, at a certain point in time, decides that it wants to sell the remaining stock as quickly as possible. Thus, in various market or competitive circumstances, competitive pricing behaviour can result in the ability for a customer to purchase at a price that is significantly lower than long-run average total costs. However, if a business sold all its products at prices below such levels, financial ruin would be the inevitable outcome.

Insurance is not characterised by these and other characteristics that can be exhibited by many other consumer products. Thus, the sort of aggressive price discounting for other goods and services (which can be facilitated by aggregators) is unlikely to ever occur in retail insurance markets. In a technical pricing sense, insurance is underpinned by the need to 'average cost price' every sale. Then, based on what risk information about, say, a house (and/or its owner), predicts will result in a worse (or better) than average claims cost outcome, the insurer will use its pricing intellect to increase (or decrease) that average or 'base' premium to maximise the chance that they are charging a premium that will result in that particular sale achieving the relevant profit target.

The insurer tries to ensure that each policyholder pays a premium commensurate with the risk (in terms of predicted claims costs) that they bring to the insurance 'pool'. If, through risk selection, an insurer can compile a pool of risks that has a lower average claims frequency and/or smaller average claims cost than its competitors, it will be able to put more competitive premiums into the market and/or earn a higher return on the capital provided by its shareholders.

The uncertainties of risk pricing mean that insurers will, despite their best efforts, inevitably under-price some risks and over-price some others (but, hopefully, get the majority about right). Insurers will not intentionally exacerbate this mispricing 'problem' by randomly selling some policies at an above-target profit and some at a loss (eg during a bout of aggressive price discounting), relaxed in the knowledge that some resulting arithmetic average profit will automatically deliver a sustainable financial return.

In some markets, it is possible for a business to sell some of its products at below long-run average total cost (ie at a 'loss'), which can be offset by profits on other sales so as to generate a total revenue in excess of total costs and, hence, make an overall profit. However, intentionally selling an insurance policy below its 'technical price' is in fact a mispriced sale. To do so would directly undermine the insurer's risk selection objectives and actively attract customers that, according to its own pricing intellect, are likely to result in claims costs that exceed any profit that policy could ever generate. Indeed, the claims costs from such under-priced policies can outweigh all the premium revenue received from the original sale and any subsequent renewals, along with all the profit from many other policies sold. Thus, the pricing of insurance (compared to many other products) is such that the latent "price competition" the FSI report suggests will magically materialise if insurers are forced to participate on aggregators, does not in fact exist.

Indeed, the reverse is true. A widespread use of aggregators would allow the inadvertent 'price competition' insurers unknowingly engage in due to the mispricing of risk to be rapidly exposed. This will result in insurers accumulating concentrations of under-priced risk, which will reduce their premium pool and profits, leading over time to an increase in average premiums. The Australian Prudential Regulation Authority made this point in its submission on the FSI's Interim Report, stating:

> *"…insurance pricing is not an exact science and different insurers will typically have different prices for the same risk. This means that, at any one time, an insurer will likely be underpricing some risks, and over-pricing others. The use of aggregators can lead to insurers winning a disproportionate share of business for which they have inadvertently under-priced. This will adversely affect their profitability and the profitability of the industry as a whole. Insurers may respond by increasing premium rates to allow them to continue to earn an acceptable return to shareholders." (p17)*

Could forcing insurers to participate on aggregators put upward pressure on premiums and/or reduce competition?

One way insurers seek to minimise their average claims costs is through the spreading of risk, for example, across their exposure to different perils (eg cyclone, bushfire, earthquake) and, as discussed, through risk selection and risk pricing. Risk spreading is used by insurers to avoid accumulating large exposures to particular risks, for example, from a concentration of business in a geographic area that is prone to a particular natural hazard. Concentration risk is one of the key factors underpinning (ie limiting) insurers' appetite for business in areas prone to particular natural disaster risks.

Insurance is not a product where an insurer will seek to maximise its share of the entire market or sell 'as much as possible'. The largest natural catastrophe risk modelled by Australian insurers for capital and reinsurance purposes (and, consequently, price setting) is a Sydney earthquake. No Australian insurer would want to insure every house in Sydney. If they did, the resulting concentration risk would flow through into higher capital requirements and reinsurance costs. This would make that insurer uncompetitive in the Sydney home insurance market when the resulting capital servicing requirements and catastrophe reinsurance costs were allocated to, and incorporated into, the premiums for those risks.

For the same reason, no insurer would want to insure every flood prone property along the Brisbane River (or any other watercourse), or insure every bushfire-prone house in the NSW Blue Mountains, or every house in cyclone-prone northern Australia. In some areas, such as Nth Queensland, it is quite likely that most, if not all, insurers already have their appetite for home insurance risk fully satisfied, and they will have in place distribution and pricing strategies to ensure that their exposure to cyclone risk remains at target levels. Allianz notes the results of the recent One Big Switch home insurance campaign, which failed to find an insurer that wanted to offer the campaign's discounts to properties vulnerable to flood and cyclone.

In these circumstances, how would an insurer respond if it was required to participate on a home insurance aggregator? As discussed, the natural inclination of customers will be to direct their purchasing attention to the lowest priced policies on such an aggregator. If an insurer already had its appetite for, say, Nth Queensland cyclone risk, satisfied, it would respond in one of two ways (or ultimately possibly both):

- First, an insurer that did not want to accumulate more exposure to cyclone risk would seek to ensure that it was not a lower priced provider of cover on the aggregator. This could be achieved by increasing prices to ensure other competitors' prices were lower. Thus, forcing insurers on to aggregators could in fact lead to upward pressure on premiums for some consumers.

- The second approach, which might be adopted simply in response to being required to participate on an aggregator or in response to the failure of increased prices to achieve the desired objective, would be to cease offering home insurance in Nth Queensland. Thus, forcing insurers on to aggregators could result in some ceasing to offer cover in particular areas or to customers whose properties exhibit particular characteristics, hence, reducing competition.

Either or both of the these responses might be adopted in many circumstances where forced participation on an aggregator disrupted the balance between retention and new business growth the insurer had achieved through its preferred pricing and distribution strategies. Insurers could adopt similar strategies in respect of properties vulnerable to any perils characterised by geographic exposure accumulation risks, such as areas prone to flood and bushfire. For example, Allianz notes that at least one smaller insurer ceased writing business in the NSW Blue Mountains following the bushfire that occurred in October 2013. On a market share basis, this company was unlikely to have suffered more than 2 total loss claims due to the fire. Thus, it did not take much to prompt adoption of the second approach above, and that was without that insurer being forced to have its Blue Mountains home insurance premiums on an aggregator.

Would home insurance aggregators help consumers purchase the most appropriate cover, or just confuse them more?

It is claimed that aggregators, including for all types of insurance, improve transparency and help consumers more quickly identify the best (ie cheapest) policy available. For simple products, where consumers need only provide a small amount of information about themselves and/or their preferences, this may be the case. For example, for an iPhone, the consumer only needs indicate their preferred model (of which there are three), how much memory they want (16, 32 or 64 GB) and, more recently, which of up to five colours they prefer. To obtain an airfare quote, a customer only needs to indicate the departure and destination city, the dates of travel and (depending on their financial means) the class of travel.

There are also insurance products that, due to their relative simplicity from a risk rating perspective, where aggregation is relatively straightforward. For example, for Compulsory Third Party insurance in NSW, insurers only apply about five risk rating factors relating to the vehicle (eg age), the owner (eg age) and the broad geographic location of the vehicle (eg metro or non-metro) in the calculation of the premium. The FSI report refers to the use of aggregators in other classes of insurance, such as health insurance and travel. Health insurance is community rated, which means it is effectively not risk rated at all. The only information a consumer needs to provide to obtain a quote on a health insurance aggregator is their age and gender. Similarly, obtaining a travel insurance quote is possible by answering less than five questions (ie broad regional destination(s), dates of travel, number of travellers and age of the oldest traveller).

Home insurance, on the other hand, is a much more complex insurance product from a risk rating perspective. To obtain a quote and/or purchase home insurance online, insurer websites will commonly require the customer to answer around 30 questions related to the owners and occupiers, the building structure (construction materials, age, size, features etc), the location, ownership, financing and security features of the property, and the list goes on. While many will be common among insurers, differences also exist. For example, questions vary for different types of home insurance such as defined events, accidental damage and full replacement policies. Policies may also contain various options (eg flood, electrical fusion, specified items etc), as well as the ability to vary the claims excess, or the insurer may offer discounts or special deals, at particular times or depending on other policies held (ie multipolicy discounts). To ensure an aggregator was able to provide consumers with an accurate price, the cumulative combination of all the questions asked by all insurers would need to form part of the aggregator's question set. It is likely, therefore, that the number of required questions could approach, or even exceed, 100.

A consumer seeking the lowest overall home insurance premium may also be interested in separately comparing the different prices insurers charge for building and contents. To just display the range of different home cover types and major options for Allianz would result in more than eighteen prices[10]. Given there are dozens of home insurance underwriters in the Australian market with a similar range of policy options, the consumer would be confronted with hundreds of different products and prices to 'choose' from. If products sold through various intermediaries under their own name (eg banks) were also required to be placed on the aggregator, the consumer would be confronted with many more potential product options and prices. For example, a search for the limited number of home insurance products currently available on the Canstar website generates around 80 choices, and the website itself indicates that the "search results do not include all home insurance providers".

Apart from the possible customer confusion arising from being presented with potentially hundreds of products and prices, as indicated earlier, Allianz has no faith in the ability of an aggregator to fairly and accurately present the non-price benefits and features of our policies. As discussed, it is Allianz's view that the two-page home insurance Key Facts Sheet insurers will be required to provide to customers from November 2014 is fundamentally flawed in its ability to provide meaningful and comparable information to consumers. If a government endorsed and prescribed document has failed to achieve this seemingly straightforward objective, what hope does an aggregator have, particularly, when the policy features and benefits it decides to highlight will be chosen at its own discretion. Related to this, Allianz is concerned that some existing home and car insurance aggregators have ownership links with insurers, which creates a potential conflict of interest in respect of issues such as the aggregator's discretion to decide which non-price policy features will be highlighted and even which prices will be displayed given many insurers have different levels of cover and default claims excesses, which will impact the price.

On a further issue related to the KFS, regulations require that consumers be provided with a KFS when they even simply enquire about home insurance (let alone obtain a quote or purchase a policy). For example, when a quote is offered, a KFS must to be provided to the customer (with fines of up to $25,500 per offence for non-compliance). The nature of the KFS requirements (and another of the regime's flaws) is such that, for many consumer enquiries or quotes, Allianz will need to provide the customer with four KFSs (one each for building and

[10] That is, three different types/levels of cover, home and/or contents and with or without flood cover.

contents insurance, and both for our two main different types of cover). Other insurers will be in a similar (or worse) situation.

Allianz assumes that this KFS obligation would fall to the aggregator (as it does to all insurers' distribution partners under the incoming KFS regime). Putting aside the additional cost burden created for insurers, who need to supply the KFSs to any agent distributing their products, in light of the discussion above, if an aggregator site generated hundreds of quotes, the aggregator would be legally obliged to provide the consumer with at least that many KFSs (eg a quote for home insurance may require provision of a separate building and contents KFS). Even if provided electronically, the consumer would be overwhelmed with documents. However, the consumer can also request that hard copies of the KFSs be sent to them by mail, which home insurance distributors are legally obliged to do.

Conclusions

Allianz's submission has sought to highlight a number of the first-order issues that arise from the proposition that insurers be forced to participate on aggregators. In particular the:

- lack of any evidence of a market failure to justify forcing commercial entities (ie insurers and aggregators) to do business with each other, which is a virtually unprecedented form of regulatory intervention that Allianz cannot readily identify as having occurred in any other area of Australia's market economy;
- complications that could be created in terms of Australia's financial services licencing regime and consumer protection laws;
- potential adverse impacts on consumer outcomes (eg underinsurance, disclosure, informed decision making) from the unrelenting focus on price over qualitative product differences that aggregators generally induce;
- negative impact on insurers' incentives to invest and innovate as a result of having its intellectual property effectively exposed to appropriation (indeed, theft) by competitors and other commercial enterprises;
- exposure of hidden, unidentified or underlying cross-subsidies (intentional or otherwise) leading to increases in premiums and/or a reduction in competition due to the withdrawal of cover for some consumers, for example, homeowners highly vulnerable to specific natural disaster risks; and
- increases in average premiums resulting from the exposure of insurers' unintentionally under-priced risks and the resulting accumulation of lower premium and unprofitable business.

There is also a range of second-order issues and practical questions arising from this form of regulatory intervention. These include:

- how many aggregators would insurers be forced to participate on? More than the ten identified earlier plus any others that wish to enter the market? Or a smaller, selected number? If the latter, how would the government select them?
- who would pay the significant costs that insurers and aggregators would incur in establishing and maintaining the IT and other capabilities required to enable automated quotes to be obtained by multiple aggregators from multiple insurers' systems? Would each party bear its own costs? Or, would the government force insurers to enter into commercial arrangements with aggregators to ensure they were commercially viable? What would happen if such a commercial arrangement could not be agreed?
- would insurers be forced to put all their policies on aggregators? Or, could they create separate no frills, lower 'quality', reduced service level, cheap products (which may leave customers underinsured) specifically for the aggregator, as has occurred in other markets (eg the UK) where insurance has become highly aggregated.

Should the FSI recommend that insurers be forced to participate on aggregators, Allianz looks forward to the final report's thoughts and analysis on some, if not all, the issues raised in our submission. While it is recognised that it is not the FSI's role to fully design the regulatory regimes it might recommend, Allianz assumes that it would give thorough consideration to the pros and cons of any such recommendations and provide stakeholders the benefits of those considerations in its final report.