

WHERE HAS ALL THE COMPETITION GONE?



One of the most talked about topics over dinner in Australia is property, typically focused on whether prices are going to go back up or whether we are in a buyer's or seller's market to time any purchase or sale. Understanding the multiple drivers of property movements is enormously complex, but at its heart lies the fundamental laws of demand and supply. Very simply, the less houses on the market and the more buyers, the higher the price.

One key component within these laws and the subject of this paper is the extent of competition. As an example, one assumes that the more bidders on a property, the better the auction price for the seller. Data sourced on bidder interest showed that the average number of bidders for one auction agency went from 4.7 to 2.9 for the periods from February to April of 2017 and 2019 respectively. From this, we intuitively might infer that reduced competition must naturally have played a significant role in driving property prices down over this period. Of course, it's more complex than this as we can't break out the extent of cause and effect (sentiment being a key aspect of this), but the competitive landscape contributes to defining whether the property market can be better for buyers (e.g. where there are few bidders) or better for sellers (e.g. where there are many bidders). And in response to the landscape, buyer and seller behaviours adapt to optimise their outcomes.

Like real estate, the life insurance competitive landscape has radically shifted, in response to a number of factors. This paper explores the competitive tension within the industry, seeking to understand whether we are in a buyer's or seller's market, the drivers of changes in supply and demand, and ways to optimise the current system in the best interests of the end 'users' of the risk product, that being the ultimate policyholder (consumers).

THE 30 SECOND STORY

This story is one of the impact of reduced competition for consumers.

There is an oligopoly situation in Australia, as the insurance industry has consolidated. The lack of competition is being exacerbated by insurers holding more risk and thus squeezing out their traditional wholesale suppliers (reinsurers). APRA has taken (arguably justifiable) parallel action to manage its prudential risk pillar but potentially this too could reduce competition. Whilst the need for sustainability is a core requirement of our industry, none of this is good for consumers as less competition usually leads to higher prices.

As a principle, buyers of insurance need to maximise their exposure to competitive tension and since there are so few insurers, the answer might lie with improving access to the capacity of the wholesale providers.



Competition in theory

Perfect competition is a theoretical market structure in which there are a large number of sellers and buyers who all have perfect information and are competing against one another to buy and sell a single product. Under such 'perfect' conditions, the optimal outcomes for consumers is achieved since they will always choose the seller with the best (lowest) price. If one seller decides to undercut its competitors and can still remain profitable, then all other sellers must follow the price change in order to stay in business. Competitive markets encourage innovation to reduce costs or provide consumers with a higher quality product to get an edge over the competition.

The polar opposite of a 'perfectly' competitive market is a monopolistic market. This is a market structure where there is a single seller who has total control over the entire market. They are free to set the price of goods however they please since there are no alternatives for consumers to turn towards. This leads to significantly worse consumer outcomes than under a competitive market as there's no incentive for the seller to innovate and provide consumers with better prices or even better products.

In between perfect competition and the monopoly structure there are a range of outcomes, but one notable middle ground structure is called an oligopoly, in which there are a small number of large sellers who are the dominant players within the market. Examples of oligopoly include the auto industry, telecoms, and commercial air travel.

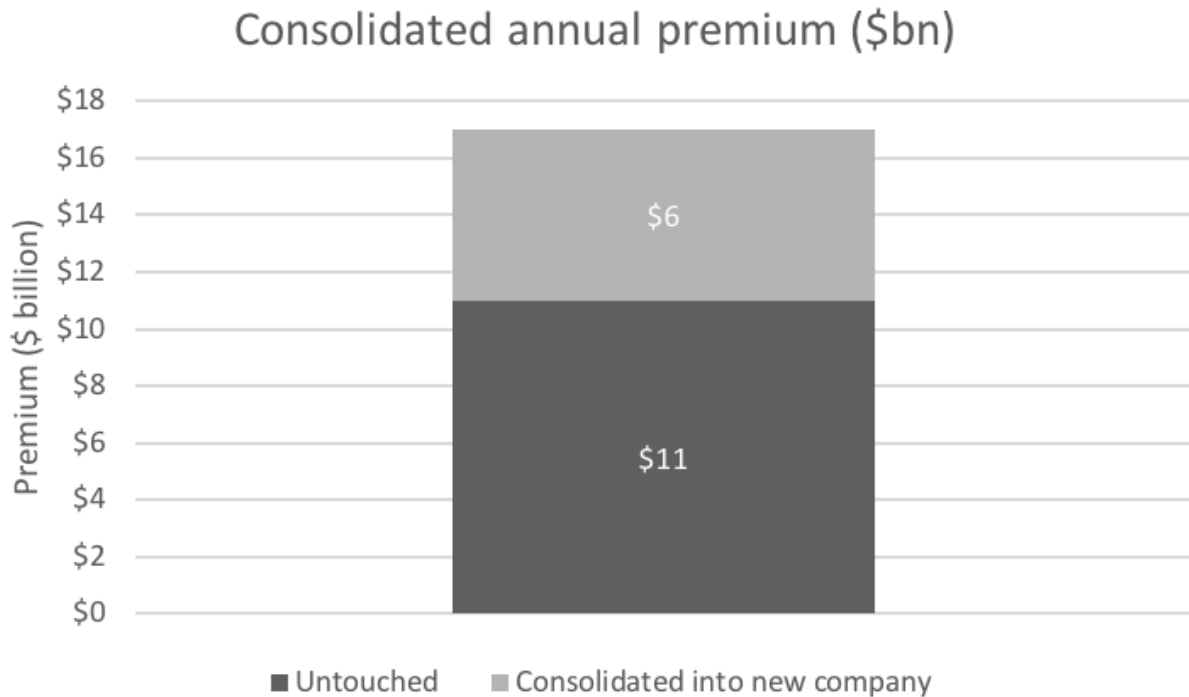
Insurance industry trend

In terms of the number of large insurance providers, the life insurance industry appears to be shifting towards less and less competition, perhaps heading into more of an oligopoly type structure. This has been driven by a number of factors:

- Regulators – as an example, recent ASIC reviews and the Royal Commission have led to a number of business models effectively disappearing overnight;
- Distributors – as an example, changes to financial advisor practice and education requirements, increased compliance costs, reductions in future commission levels and a shift away from vertical integration is driving advisors in the retail space to exit;
- Business Performance – sustained poor financial performance, reinforced by the repeated blow to reputation from scandals and mismanagement, has both impacted market volumes as consumers turn away and driven strategic reviews by some companies who have concluded that the challenges of doing business are outside their risk appetite.

The overall effect of these and other changes has been two-fold: a reduction in the size of the pool of consumers who are being insured, with associated reductions in potential scale benefits for market participants; and a consequent consolidation within the industry.

Of the c\$17bn in annual premium across life insurers in 2018, an estimated 35% of this will have been consolidated into another entity (or closed to new business) post 2019.



Source: Retender estimate

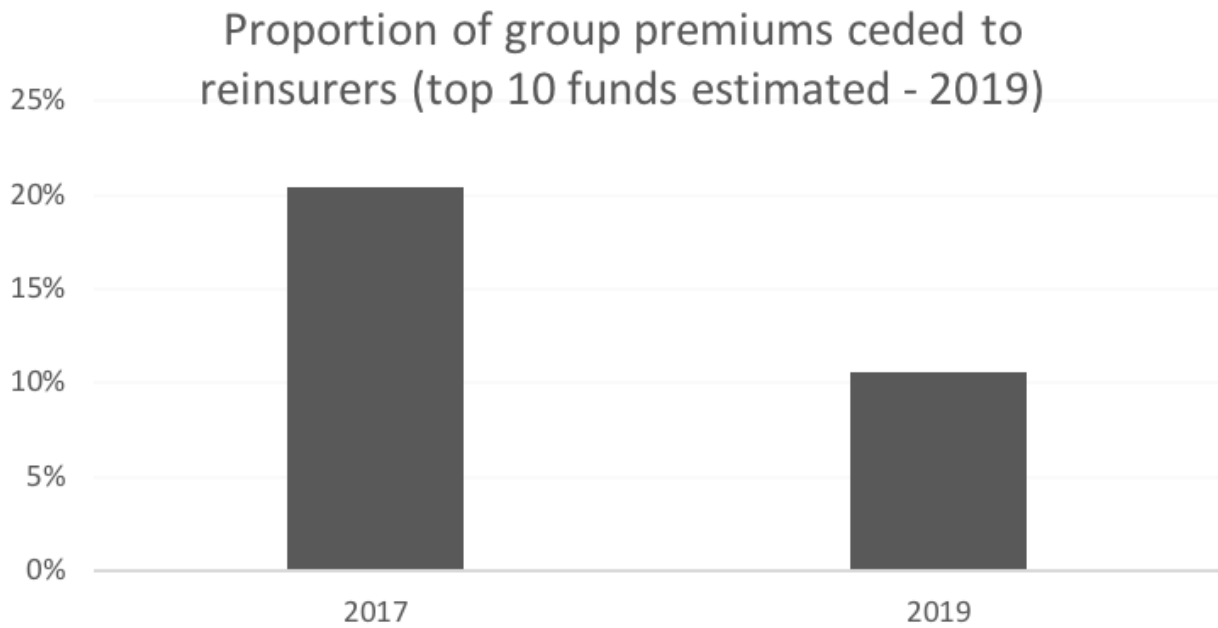
All things being equal, the smaller the supply, the more likely that prices can rise to reset profitability levels. From a shareholder’s perspective this is good news. Arguably the recent consolidation is a result of competition, as the ‘weaker’ players exit and the stronger survive. For an industry that has not made money for years, this provides an opportunity to reset profit levels and take advantage of scale.

However, from a policyholder perspective, and the lens through which this paper has been written, the favourability of outcomes is less sure.

Magnifying the supply constraints

Consolidation in itself might be appropriate when it leads to increased sustainability. However, what happens next in this construct cannot be overlooked and there are two particular changes which magnify the impact for consumers.

The first is that supply is being reduced as insurers retain more and more of the risk. As the gatekeepers of access to reinsurers, they can choose to cede as much or as little risk as they like and retain any implied value created, which in effect is a means of controlling competition for the risk. In group insurance, for example, Retender estimates that for the top 10 largest funds the proportion ceded to reinsurers will have almost halved by the end of 2019, from 2017 levels.

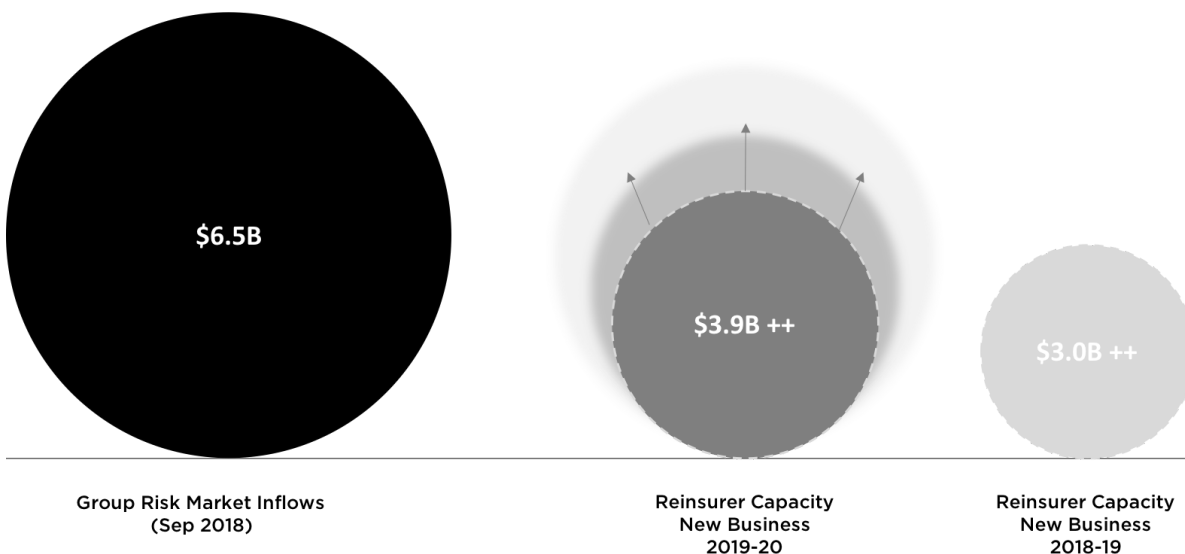


Source: Retender estimate

This does raise the question of whether insurers have considered carefully the principle that by increasing their exposure to offset falling revenue, they are correspondingly increasing their risk of greater losses too (greater profits cannot be assumed).

There are 10 reinsurers operating in the Australian market, with significant capacity available to deploy in this channel, compared to the 3 core insurers (with another 3 second tier players) who are active in group insurance.

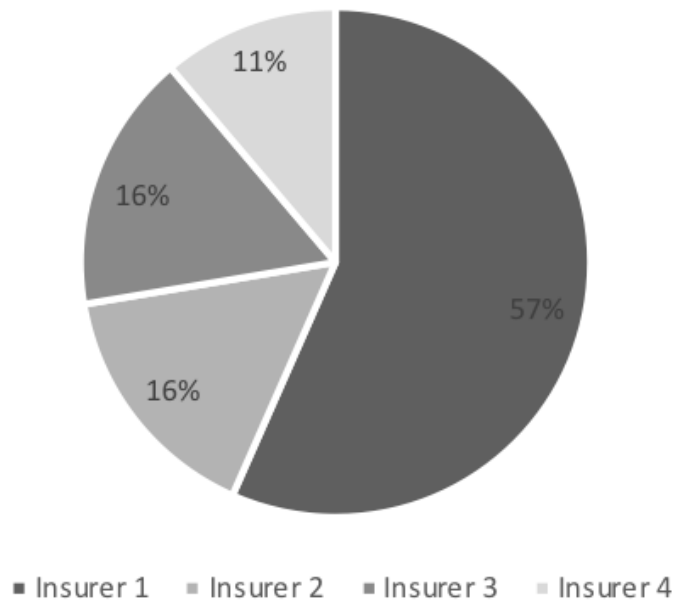
Retender's annual survey of reinsurance capacity in 2019, highlighted that the reinsurance market had well over \$3.9bn of new capacity theoretically available in group insurance. Where this capacity cannot find its way into the market, this effectively stifles competition.



Source: Retender reinsurance survey 2019

Market dominance is further exacerbating these issues. For example, in group insurance, the largest 10 funds are only insured by 3 insurers plus one captive insurer set up by the fund. Indeed, the market share of one of these large insurers is expected to exceed 50% of the market post 2019, entrenching the oligopoly model and ability of a few participants to influence future market outcomes.

Estimated market share of top 10 funds - 2019



Source: Retender estimate

The second change is consolidation in the number of super funds, ordinarily creating bigger entities with more buying power. However, one example where this leverage has had little value has been around the recent legislative changes of the Protecting Your Super (PYS) package. Funds have been given a short window, driven by government policy rather than of their own doing, to assess whether updated insurance terms reflecting these legislative changes are appropriate. In effect, funds have had to conduct a repricing exercise with little to no competitive tension and accept the only offer available in order to meet a government-imposed deadline of 1 July 2019.

As one fund described, they have recognised they are price takers and given the operational complexity (perhaps impossibility) of changing insurers, have had no choice but to accept the terms offered to their members. Future legislation changes, in particular Putting Member's Interest's First, will need to take some lessons away from the PYS exercise to ensure real competition is created. Use of any test of 'reasonableness' is no longer appropriate in the current environment, particularly when the legislation requires a 'best' interests test.

One mechanism which also needs to be considered is the impact of profit shares. These largely emerged post 2013-2014 in response to the funds believing that the premium increases required were overdone. Profit shares were traditionally a more one-sided mechanism for any excess profits to be passed back to the members (and this came at a cost). However, some funds also took on a large part of the downside risk, turning insurance into a partial loss deferral mechanism rather than a loss mitigation mechanism.

The two-sided nature of these modern profit share structures has immunised insurers from much of the potential volatility in outcomes. That has led to a substantial increase in risk appetite for a number of key insurers, and arguably diluted competition as a result. Similarly, models that propose spreading of pricing changes or true up's of the actual experience emerging are sub optimal in that they either require long term contract lock in's or again pass the risk back to members.

Co-operation in an oligopoly

Historically there are examples in the life insurance industry where attempted co-operation has failed such as agreement on the treatment of legacy products, leading to a continual spiral of losses on disability income. On the other side, the industry has co-operated well to manage the PYS message or the introduction of a code of practice.

However, sometimes co-operation can work against competition and one important example is around restrictions on data availability. The Productivity Commission found (or maybe confirmed) in 2017 that Australia is behind a number of comparable countries on data provision ('Australia's provision of open access to public sector data is below comparable countries with similar governance structures, including the United States, the United Kingdom and New Zealand...'). In the insurance industry in particular, data is controlled by a small number of parties (and only one party doing the analysis) and generally only available, in contrast to other countries like the UK, for a significant fee. This lack of data supply has impacts on research, risks of mispricing for new entrants and ultimately sustainability.

Data provides an example where the regulator could step in to support competition. The Actuaries Institute recently wrote to APRA in March 2019 suggesting that APRA go beyond mandating collection of claims data and instead mandate increased sharing of experience analysis across the industry.

But what happens when, where co-operation has failed, the regulator steps in and the unintended consequence changes the competition landscape?

Regulatory nudge too far

APRA's core role, amongst other things, is ensuring prudential stability i.e. that insurers remain solvent to meet their policyholder liabilities. A company continually losing money (or expected to lose money) poses the real risk of policyholders not being paid out claims at the time when they need it most. However, its purpose defines that 'APRA is to balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.'

Recently a number of developments have perhaps raised some questions of how this focus on prudential stability works in tandem with creating competition. For example:

- Since APRA has to approve any life insurance company sale, how is competition balanced where we are witnessing such a significant consolidation effect across the insurance industry? Arguably size brings down consumers fees through scale benefits, but is it possible as we shift into more of an oligopolistic environment, there is an inflection point where the change in supply is to the detriment of consumers? This is especially true of the group risk market, where the potential scale benefits are a fraction of the overall risk cost.
- Recently APRA has published a letter on disability income in retail advised insurance. For years the industry has continually lost money and been unable to reset prices onto more sustainable rates (in part driven by the impact on first movers from the easy movement by healthier consumers to alternative providers). APRA has given the industry a narrow timeline to take action, in effect putting the industry on notice to self-correct. Whilst important for capital stability, this invariably will lead to price increases for consumers with income protection products. Should one consider that competition has held down prices whereby participants have made commercial calls to accept cross subsidies but now the industry is being given an opportunity to collectively raise prices?
- APRA recently undertook a review of counterparty exposures within one of their prudential standards (LPS117). The initial proposal here was to halve the level of exposure any local insurer can have to an offshore specialist reinsurer, at the same time proposing that the levels that can be retroceded internally to a related entity can more than double. Again, does this stifle competition? This is worth considering in the context that although offshore reinsurers weren't active pre 2013 in Australia (see later), the recent crisis in both group and retail risk were precipitated by local insurers and reinsurers. However, being able to properly supervise overseas entities is a balancing item which should be considered where any risk is being placed into non-APRA regulated jurisdictions.

There are multiple dimensions to what is in the best interests of consumers, and we raise the question whether the balance has shifted too far where an indirect 'over pursuit' of a few single dimensions to the exclusion of others could lead to adverse consumer outcomes?

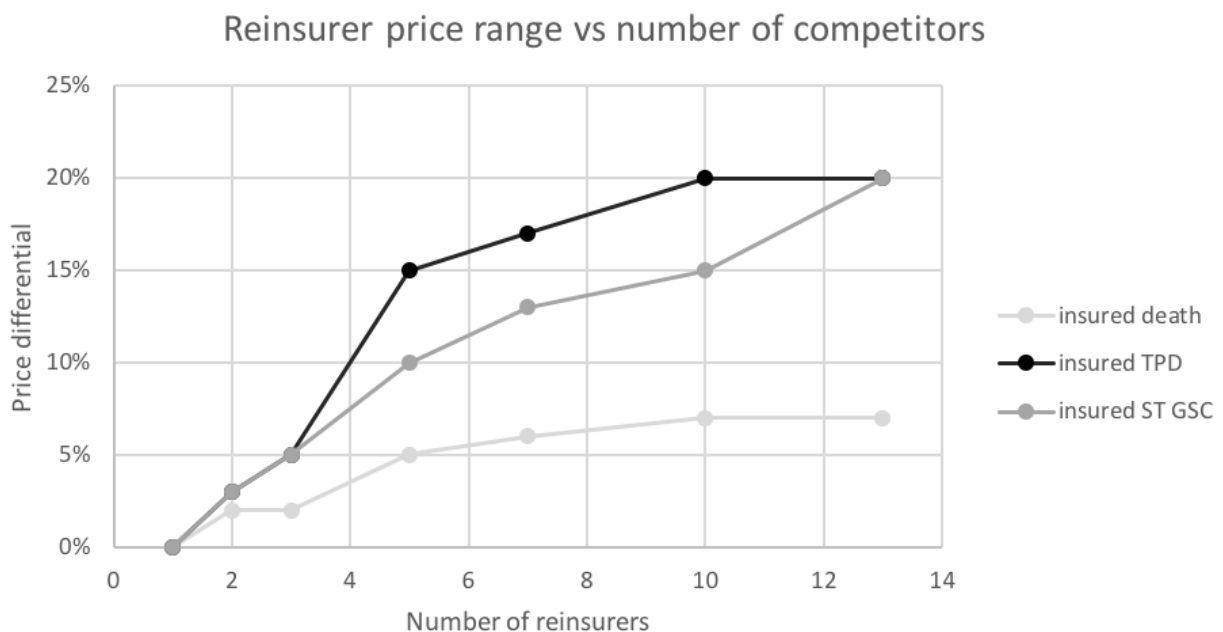
Is more competition always better?

With the logic of competition, the more bidders that participate at an auction, the more money the auctioneer will make; or in the case of a tender, the more bidders that participate, the lower the price for the party calling the tender.

In terms of theory, Bulow and Klemperer (1996) showed that if bidders have standard preferences, an auction with $N + 1$ bidders and no reserve price yields a higher expected revenue than an auction with N bidders and an optimally set reserve price. As they outlined in their paper, 'a seller with no bargaining power who can only run an English auction with no reserve price among $N + 1$ symmetric bidders will earn more in expectation than a seller with all the bargaining power, including the ability to make binding commitments, who can hold an optimal auction with N buyers'.

It's intuitive in that, like the property market bidding, the more bidders, the more likelihood different parties will have different views on the price and value in this variability can be extracted for the seller.

Extending into the life insurance space, we can make assumptions about the variability of terms under different benefit lines as the number of participants increase and from this, model the theoretical benefits that emerge as the number of participants increase.



Source: Retender modelling

As a sense check on the theory, Retender have observed even wider (and at times surprising) variation than modelled in practice, highlighting how different parties always have different appetites and capacity for different lines of risk.

Interestingly, there is a fascinating paper (to provide a counter argument) from the University of New South Wales which suggested, for real world objects, the more parties participating, the lower the odds were of winning the auction leading to less aggressive bids. In addition, where parties were aware of the number of competing bidders, this tended to lead to worse outcomes. However, the study does differentiate between real world objects (buying goods) and induced value objects (e.g. monetary vouchers) and find that their results don't hold for the latter which is arguably more akin to financial outcomes.

We can't manufacture insurers overnight

The barriers to entry for insurers are significant. When one includes the time required from initial concept through to raising capital through to receiving a life insurance license, the exercise can take many years. So whilst we can't easily increase supply, are there opportunities for the buyers of insurance to increase their access to competition and competitive pricing?

One possibility is to optimise the bidding process. Increasing supply is the key focus here and there are a number of avenues to achieve this outcome. For one, any model that increases the number of bidders is a primary goal. Another area is to consider how the outcomes would be different if there was expected to be more than one winner and the extent to which this increases supply. As an example, traditional models focus on one winner only so in any insurance tender where a reinsurer participates, despite the fact that there may be, say, only 3 insurers and 5 reinsurers, any one reinsurer's chances of winning the business would be $(1/3) * (1/5) = 1$ in 15 chance or a c7% probability of winning. Given tenders can take 6-12 months and are enormous resource drains, why would risk carriers want to participate in an insurance tender with such low chance of success? In contrast, under a reinsurance tender where the insurer has already been preselected, and say 2 reinsurers share the risk, their probability of winning a share would be $(2/5)$ or 40%. Models which improve chances of success for the sellers of insurance risk are therefore expected to introduce greater supply into the process and this has been borne out in practice. Multiple parties also increase diversification and optionality which are important aspects for both buyers and sellers.

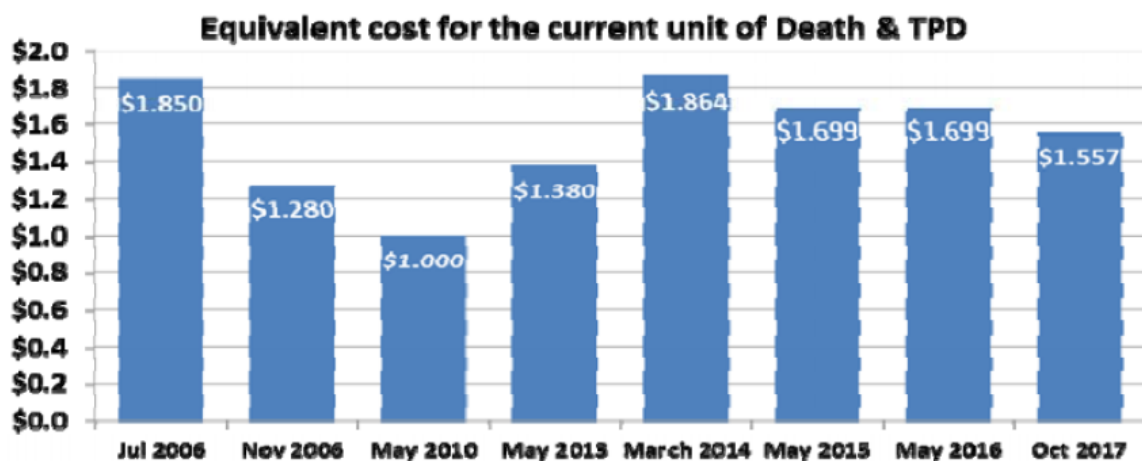
On the softer side, taking some lessons from the studies, we can introduce greater levels of independence and transparency whilst at the same time removing biases in the process (as an example, parties not being aware of the competing bidders).

One potential enemy of competition worth noting is that of sustainability. Despite cheaper prices being available, should funds place all of their risk with one party that could be mispricing the risk or change appetite overnight? Putting aside the frictional costs and disruption of changing insurers, a weaker insurance industry is not good for consumers in the long term, and large movements in premium rates over short periods are undesirable from a policyholder or members' best interests perspective.

Lessons learned

It wasn't so long ago that the insurance and reinsurance industry expected to make significant losses in group insurance. In the lead up to the 2013-14 meltdown, market pricing had been soft, with insurers and reinsurers chasing each other to the bottom in an effort to win new business.

But in 2013-2014, insurers and reinsurers withdrew capacity, leading to a shock increase in premium rates (some over 100%) followed by years of significant reductions in prices as it became clear that the projections were overly conservative. Insurers avoided the losses of 2013 because most of their risk was reinsured (usually one party), but today we are seeing insurers increase their levels of risk retention which in effect exposes them to the same risks that reinsurers faced in the prior cycle. From a systemic risk point of view, now that we are in an environment where there is even less supply (fewer insurers), holding even more of the risk (reinsurers being shut out), with lumpier risk pools (as funds consolidate) and uncertainty increasing, the question is whether the lessons of the risk of price instability have truly been learned or are doomed to be repeated.



Source: AustralianSuper insurance pricing - webinar October 2017

More broadly, when competition dries up, a small number of parties can impose outcomes on an industry. While that is commercially legitimate, competition is a key requirement for a sustainable industry and ensuring consumers get the best possible deal. And in particular, diversification for the buyers of risk is still one of the most obvious solutions to ensuring that capacity and competition is maintained throughout any cycle.

So what?

Buyers of risk need to consider the competitive cycle when purchasing their insurance as competition is by far one of the core drivers of optimal outcomes for consumers. Introducing bidders into any pricing review (as opposed to 'reasonability testing' or passing risk back onto consumers) is required to ensure that consumers have access to the best outcome. Front end insurance tenders introduce significant complexity, time and cost but a solution lies with using the wholesale market (reinsurers) to ensure competition is being generated. In group insurance for example, where 80%-85% of the premium relates to the risk, this approach optimises the competitive tension whilst minimising the operational complexity.

Regardless of the model, buyers have an obligation, sometime by law (the 'best interests' and 'outcomes' tests) to demonstrate that real and executable competition has been introduced.