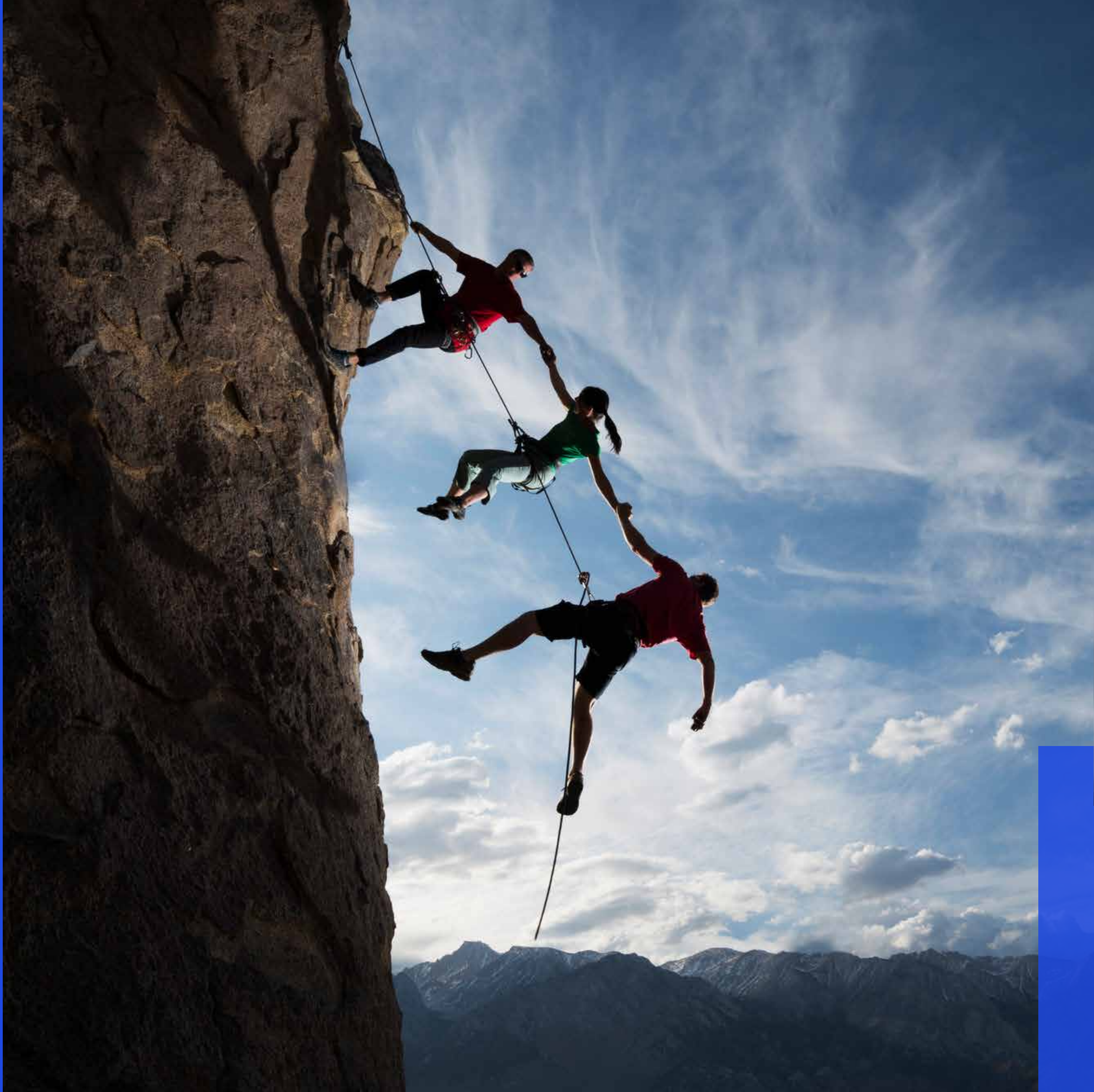

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# Insurance pricing and TCF

**After many years a cold caller catches you in a good mood, so you decide to humour them and get a competitor quote on your motor or household insurance policy. How does it make you feel, when you have been loyally paying your insurance premiums for several years, only to discover that you can get what seems to be an equivalent product at a significantly lower price? Are you elated to be able to save some money going forwards or are you upset about having paid more than you could have for the last few years?**

The question of differential or marginal pricing is getting more and more attention by international regulators and I thought it would be interesting to explore the fairness of insurance risk pricing in this article.

## The economic theory

For any business getting your pricing right is key with the most obvious trade-off in insurance between sales volumes and profitability:

- If you charge too little, you could take on loss making business that ultimately puts pressure on your solvency, or at best you are leaving money on the table that could be used to expand your team, refine your offerings and grow your business.

- Charge too much, and you might chase potential customers to your competitors. Low sales volumes can also lead to reduced profitability and ultimately puts pressure on your solvency position.

Whether you are a professional responsible for determining your company's pricing strategy or an entrepreneur on the verge of launching a new product or service, it is vital to understand how much your customers are willing to pay. Businesses have a profit incentive to determine consumers’ willingness to pay for their products or services.

From an economic perspective the optimal selling strategy to achieve growth in profitability levels would be to charge customers different prices for the same product or service based on what the customer is prepared to pay.

To achieve this, businesses often research their markets to understand the price elasticity of demand associated with different customer groupings based on specified attributes. Whether price discrimination works and for how long the various groups are willing to pay different prices for the same product depends on the relative elasticities of demand in the sub-markets. If targeted customers remain loyal even when prices or premiums are increased, then greater profit margins can be achieved by differentiating prices in that sub-market grouping.

An example of price discrimination that most readers of this article would be familiar with is the dynamic pricing experienced in the airline industry. Consumers buying air tickets several months in advance typically pay less than consumers purchasing at the last minute. When demand for a particular flight is high, airlines raise ticket prices in response. By contrast, when tickets for a flight are not selling well, the airline reduces the prices of available tickets to try to generate sales and increase sales volumes.

With the rugby world cup currently underway there are many who have paid for the right to view the games through their annual premium television subscription services, which often also gives access to numerous other channels. Is this not an example of where marginal pricing could be used by service providers to capture their regular subscriber market but also create a less expensive package that gives access to only the rugby world cup games for the two months of the competition? This would service a need for the part of the market that only wants to watch the rugby world cup but does not want to pay for the other services or cannot afford to pay for the premium services for the full year.

Would consumers not be better off if everyone paid the same price? In many cases, no. Different customer segments have different characteristics and different price points that they are willing to pay. If everything were priced at say the "average cost," people with lower price points could never afford it. Likewise, those with higher price points could hoard it. Fixing static prices can lead to market inefficiencies from both the supply and demand sides. So economic theory seems to support a place for differential pricing.

## Are we comfortable with the ethics of differential pricing in the insurance industry?

We all know that tax avoidance is legal while tax evasion is not. In most cases most would agree that it is smart to legally avoid paying more tax than one needs to. On the other hand, tax evasion means concealing information from the tax authorities in an illegal way and we would all agree that is definitely not okay.

It is a little harsh to compare this question regarding the ethics of differential pricing in insurance to the difference between tax evasion versus tax avoidance. However, people would have differing views on whether it is okay or not. As the jury is out, I thought I would ask for a view from ChatGPT:

## Same risk, same price

*"Is it ethical to charge loyal customers more than new customers when renewing their insurance premiums?"*

The response was succinct: *"Ethically, charging loyal customers more than new customers for insurance renewals can be seen as unfair and exploitative. It's generally considered better practice to treat all customers fairly and provide consistent pricing based on risk and coverage. Some argue that loyalty should be rewarded, not penalized. However, the insurance industry has complex pricing models, and it's important to consider the broader context and regulations that might impact pricing decisions"*.

ChatGPT points out that insurers should typically price based on the underlying risk, i.e. the same risk should be charged the same premium. However, ChatGPT goes on to say *"…it's important to consider the broader context and regulations"*.

In South Africa there is currently no locally recognised prudential framework in place regulating differential pricing practices of insurance contracts. Looking further north to Europe and the United Kingdom we have seen regulators becoming more involved in this space. There are two quite different legislative/regulatory developments that we have seen in this space.

## Different risk, same price - European Court of Justice

In 2012 the European Court of Justice ruled that it would no longer be considered lawful for insurers to take the gender of their customers into account when setting their insurance premiums. Up until that point, insurers considered gender because, for example, life expectancy or driving risk was shown to differ between males and females. In this case the theory from the European Court of Justice was that taking customers' gender into account contradicted laws on discrimination.

In practice, this ruling drove a change in the premiums affecting the relative price for various types of insurance including motor insurance, life insurance, health insurance and the cost of an annuity. The insurance industry managed this by estimating the take-up of their policies by different genders to estimate the pool of risks being taken on and therefore allow pricing of the underlying risks.

## Same risk but different price – Treating Customers Fairly

Treating Customers Fairly initiatives in numerous countries have focused on conduct risk in the financial services industry. Differential pricing needs to be considered in this context - is it fair for insurers to knowingly charge customers who represent the same risk a different premium? Regulators look for firms to proactively ensure that the organisation is treating customers fairly.

In the United Kingdom there have been some developments in the general insurance pricing space, with the Financial Conduct Authority (FCA) releasing relevant reports and policy statements including those listed below.

| Relevant FCA reports and policy statements | Release date |
|---|---|
| MS18/1.3: General insurance pricing practices: Final Report (fca.org.uk)<br>(https://www.fca.org.uk/publication/market-studies/ms18-1-3.pdf) | September 2020 |
| PS21/5: General insurance pricing practices market study: feedback to CP20/19 and final rules (fca.org.uk)<br>(https://www.fca.org.uk/publication/policy/ps21-5.pdf) | May 2021 |
| PS21/11: General insurance pricing practices – Amendments (fca.org.uk)<br>(https://www.fca.org.uk/publication/policy/ps21-11.pdf) | August 2021 |

I draw attention to an excerpt from the policy statement listed last in the table to the left:

*"2.2 Our pricing rules require that where a firm sets a renewal price, this must be no higher than the equivalent new business price (ENBP). Our rules also make it clear that the ENBP must reflect both cash and cash equivalent incentives that are offered to new customers.*

*2.3 This is to ensure that a firm with an ongoing relationship with a customer – that is involved at renewal cannot price walk by applying a cash or cash equivalent discount for new business which it does not apply to equivalent customers at renewal."*

Similarly in Europe the European Insurance and Occupational Pensions Authority (EIOPA) has recently released a supervisory statement on differential pricing practices aimed at eliminating price-setting strategies which lead to the unfair treatment of customers:

| EIOPA supervisory statement | Release date |
|---|---|
| Supervisory statement on differential pricing practices in non-life insurance lines of business (europa.eu)<br>(https://www.eiopa.europa.eu/publications/supervisory-statement-differential-pricing-practices-non-life-insurance-lines-business_en) | March 2023 |

What do you think – is this a conduct risk that you think should get more regulatory attention? Or is this something we should leave to free markets – is it not fair for insurers to charge customers what they are willing to pay?