The Economics of Insurance Markets – FCA call for inputs in relation to Big Data in retail general insurance

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Introduction

As highlighted in last year's chapter,[1] insurance markets have been subject to intense scrutiny from competition authorities in recent years. In particular, the Competition and Markets Authority (CMA) has carried out a wide-ranging investigation of the private motor insurance (PMI) market[2] and the Financial Conduct Authority (FCA) has investigated general insurance add-ons.[3] These investigations have not focused on traditional competition concerns – namely cooperative agreements between insurance companies that are the subject of the Insurance Block Exemption Regulation (IBER)[4] – but instead the entire structure and operation of markets and the extent to which consumers' interests are being served, notwithstanding that there are many providers of PMI and the various general insurance add-ons. A key concern is whether markets are exploiting behavioural consumer biases[5] and isolating competitive pressure on only the most engaged consumers.

On 24 November 2015, the FCA extended the frontiers of investigation by publishing a call for inputs in relation to the use of Big Data in retail general insurance (such as car and buildings/household insurance).[6] The FCA is seeking comments by 8 January 2016 on how consumers are affected, whether Big Data fosters or constrains competition, and how the FCA's regulatory framework affects the development of Big Data in retail insurance markets. The CMA's findings and next steps are due to be published mid-2016.

This chapter focuses on four particular points raised by the FCA's call for inputs:[7]

- Fact finding: What is the relevant market context, and what is the potential and actual importance of Big Data in general retail insurance?
- Consumers: How are consumers' interests affected by the use of Big Data?
- Competitive effects: how serious are any potential competition issues?
- Appropriate regulation?

Fact finding: The relevant market context and the actual importance of Big Data in general retail insurance

An article in Investopedia on 29 April 2015 on "How Big Data Has Changed Insurance"[8] highlights that:

> "The [insurance] industry has made progress capturing and analyzing the majority of structured data associated with their policyholders, the volume of untapped unstructured data remains just as valuable. Unstructured data refers to information sharing sources such as real time news feeds, social media and other mobile channels.
>
> To create a competitive advantage and succeed in that dynamic environment, insurers must leverage the value of big data. As underwriting continues to drive insurance pricing, big data and analytics have also had profound effects on customer insights, claims management and risk management."

Accordingly, this section considers how Big Data may be used in insurance markets for a variety of purposes, namely determining the likelihood and costs of claims, assessing consumer demand, and reducing the risk and cost of fraud.

The likelihood and costs of claims

Individual insurance markets will all have their own particular features, but it is possible to identify a number of general characteristics. A key feature of insurance is that it is sold for a known price, but the claims costs are inherently uncertain. In particular, there is uncertainty about the likelihood that the insured events will come to pass and the likely cost of claims under the cover. Unlike transactions between retailers and their customers, for example, the insured events do not occur frequently and are not encouraged by the insurers. Accordingly, perhaps the central theme of insurance markets is risk and uncertainty, both for customers (which is why they buy insurance) and also suppliers (with this also being a factor driving the extensive financial regulation of insurance companies).

As a consequence, insurers expend considerable efforts in building predictive models relating to how the precise characteristics of people, coupled with the specification of policies,[9] affect the likelihood and costs of claims. This information is valuable for insurers to assess the reserves that they need to hold to fund future claims, the extent to which they should re-insure policies to manage risk, and their pricing of insurance policies given expected claims costs. Taking a step further and using Big Data enhances the otherwise sparse information about the behaviour of their customers in a context where the way a policyholder behaves is generally more predictive than demographic characteristics such as age or address.

Even when events occur sufficiently frequently to allow insurers to form a view about likelihoods, the historical data available to individual insurers as to their own historic claims alone may not be representative of the population as a whole, which could yield unreliable estimates of risk. One consequence of this is that insurers may have an interest in sharing information between one another, or purchasing data from third parties that might assist in their risk assessments. In this regard, a particular problem for insurers relates

to "outliers", whether these are particular types of people, claims, or events that are high risk or high cost (e.g. extreme weather, which can be difficult to evaluate).

Accordingly, insurers have an interest in adding additional explanatory variables to their models in order to assess whether this assists with predicting claims. This is, of course, not new. However, what has changed in recent years is the sheer quantity of data – including data that is proprietary to the insurer, shared data and open/public source data – and the analytical tools available to assess this data. For example, websites and digital interaction generally have created the ability to monitor and measure the way in which a customer navigates a website or completes an application form,[10] thereby creating behavioural data where none existed previously. Big Data has become an economy-wide phenomenon, and is certainly impacting insurance markets. To cite an article in the Economist on "Risk and reward" from March 2015:

> "Insurers typically rely on blunter proxies to assess risk— age, sex and marital status, for instance. But assuming that all young, single, male drivers are reckless, for example, and that middle-aged, married, female ones are cautious is often inaccurate. It also involves unfair cross-subsidies: prudent and responsible young men help to pay for lead-footed mums.
>
> Modern technology enables insurers to gauge individual risk much more precisely. Monitoring devices provide a wealth of data, as do social media, credit-card histories and other digital records."[11]

Big Data may, in principle, enable insurers to assess risk much more precisely, rather than average risk across a certain customer cohort, as well as allowing additional explanatory variables to be identified that are correlated with the likelihood and cost of claims. On 8 September 2015, the Chartered Insurance Institute (CII) published an interesting publication on "Big data and insurance: a conversation" (the CII report), which emphasises that how people go about their everyday routines affects their insurance claims in many ways.[12] The CII report referred to insurers' use of data from all sources, including social media, information provided to other companies (and sold to insurers), and information provided by consumers directly to insurers, as "lifestyle underwriting". More generally, these data sources permit better segmentation by making it easier to identify the risk profiles of customers.[13]

A different, but widely cited example of the use of Big Data is the increasing use of monitoring devices that are used to measure behaviour, and therefore risks, more directly. For example, insurers are increasingly offering policies linked to the installation of telematics devices in cars that offer otherwise high risk drivers lower insurance premiums, subject to their driving being moderate and controlled.[14] Moreover, when and where consumers drive (e.g. driving during congested periods) will also affect the likelihood of a claim.

However, this should be seen in the context that the article in the Economist reported forecasts from Ptolemus that only about 7 million car-insurance policies in each of North America and Europe would be using monitoring devices in 2015, albeit that take up is growing rapidly.

Assessing demand

As consumers progress through different lifecycle stages, their insurance requirements change. A sophisticated insurer can use Big Data to identify these changes and determine modifications to existing policies as well as new policies that best suit new lifecycle stages.[15] The insurer is thereby better able to offer appropriate products, and increase the strength of its relationship with its customer versus competitors by better meeting the consumer's needs.

Big Data can also be used to assess customer price sensitivity, including the likelihood of customers not accepting a renewal quote. Indeed, the CII report states that "Insurance firms are using big data to optimise prices according to the amount they believe the customers is willing to pay". This issue is considered further below.

Managing the risk of fraud

The CII report also indicates that it is likely that insurance firms will use Big Data to obtain a general picture about what a claim will look like and then compare this with actual claims to assess whether and how they differ. Such differences do not necessarily mean that a claim is fraudulent, but outlying or unusual claims may warrant closer scrutiny.

Big Data from telematics boxes on cars may also make it easier to assess claims, including reconstructing the accident and checking if the accident was likely to cause the damage and injuries being claimed for.

These techniques may also enable "normal" claims to be paid out more quickly.

The Investopedia article also indicates that Big Data may also be used at the underwriting stage of a policy to detect fraud-likely applicants.

In this regard, it is important to appreciate that managing fraud is an important part of insurance companies' cost control. The Association of British Insurers (ABI) issued a press release on 13 July 2015 which indicated that:

> "■ Insurers uncover 350 insurance frauds worth £3.6 million every day.
> ■ Value of frauds detected at a record high.
> ■ Value of frauds uncovered in 2014 double the cost of retail crime."[16]

Factors limiting the use of Big Data

Notwithstanding the potential benefits of Big Data from the perspectives of insurers, there are a number of factors that may limit the use of Big Data by insurance companies.

First, having access to data is different from being able to turn that data into valuable information. This may be compromised by the quantity and cost of analysing the data. Legacy IT systems can add to the cost of accessing and using Big Data efficiently. Insurance companies' use of Big Data consequently varies materially. Some data that are linked to claims risks are easy to capture and incorporate (e.g. crime statistics by area or consumers' personal credit scores), but others (such as the array of personal data potentially available on customers' digital footprints) are more difficult. Despite merger and acquisition activity in the insurance sector creating scale in the data repositories of large insurers, overcoming the technological challenges of data consolidation generally requires significant investment. The returns from such investment are unknown and often the time horizon for solving the challenges is beyond the patience of many shareholders, therefore the scale benefits of data frequently remain untapped.

Second, the distribution channels through which insurance is sold may also limit the use of Big Data. In particular, price comparison websites (PCW) may limit the use of personal Big Data consumer

information to determine fee quotes beyond the information filed in on the form (which will nevertheless include address, marital status, profession and so on). In this regard, the CMA found that in 2012, PCWs accounted for 55-65 per cent of new PMI sales.[17]

Third, whilst insurers will wish to be competitive on price, they may also wish to be cautious in revising their price setting since if they under price certain risk profiles they can expect to win a disproportionate high share of both such policies and their associated claims.[18] In this regard, it is important to appreciate that Big Data does not negate the lessons from statistical analysis. Economist Tim Hartford published an excellent article in the Financial Times on 28 March 2014[19] entitled "Big data: are we making a big mistake?", which highlights a number of important points about the use and interpretation of Big Data:

- a spurious multi-comparisons problem may arise. This is because the more comparisons the researcher makes within a population, the more likely a spurious correlation will be found. In an insurance context, if you look at the myriad arrays in which insurance consumer cohorts can be broken down, there is a real risk of some correlation being found with an array of variables for certain consumer profiles;

- more generally, Big Data may facilitate the identification of correlations between variables. However, correlation is very different from causation. It can be argued that this does not matter for predictive purposes. However, as Tim Hartford observes, "If you have no idea what is behind a correlation, you have no idea what might cause that correlation to break down";[20] and

- Big Data potentially generates very large samples of consumer behaviour, and thus one might think that the results of a large sample are somehow superior to small samples. This is simply not the case as sample selection bias arises where the sample selected is not representative of the population as a whole. Increasing the size of a biased sample does not improve matters. For example, although Twitter has a very large number of users, the profile, views and behaviour of these users might not be representative of the population of car drivers.

To illustrate the last point, suppose that insurers find an adverse correlation between claims and peoples' Facebook posts, their movie preferences, or indeed any other matter associated with their digital footprint. In this scenario, consumers will have a strong incentive not to disclose such information. Similarly, consumers might be hesitant to permit their insurance company to monitor their behaviour closely via a monitoring device, absent large discounts. These factors might mean that the sample of those monitored – whether directly through a monitoring device or indirectly via life style monitoring – might not be representative of the broader population.

These latter points should not be over interpreted, not least because an imperfect measure may permit superior modelling than disregarding the additional information. However, insurers will wish to exhibit some care in developing their predictive models using Big Data.

Consumers' interests

Before considering the potential competitive effects of Big Data, it is appropriate to consider how consumers' interests may be directly affected.

We assume that it is relatively uncontroversial that preventing fraud is desirable, even if one may raise issues relating to the use of Big Data to prevent crime more generally. However, the use of Big Data to discriminate between consumers on either cost or demand grounds is perhaps less straightforward.

As regards discrimination on cost grounds to reflect the risks and costs of claims, the FCA indicates that it is interested in the extent to which Big Data is increasing the micro-segmentation of risk in relation to private motor and home insurance, and how this might affect consumers generally as well as certain groups of consumers.

However, in order to consider consumers' interests in discrimination on cost grounds, it is not sufficient to observe that Big Data is likely to lead to some consumers paying less and others more. In particular, it is important to appreciate that insurers face substantial information asymmetries that can adversely affect the market outcome. For example, an insurer may not be able to ascertain whether a customer is a responsible driver and, as a result, cannot accurately assess the expected cost of the insurance. This can result in "adverse selection" and "moral hazard".

Adverse selection stems from the fact that insurance companies cannot precisely identify customers who are more prone to making a claim (i.e. they are riskier), and thus cannot raise their premium selectively to these customers to reflect the increased risk. Instead, insurers will raise prices generally leading to cross-subsidy between low and higher risk consumers. This, in turn, means that a greater proportion of the insurance company's customers will consist of riskier customers, since they are willing to pay more for the insurance as they expect to benefit more from it, thus further raising the underwriting cost and hence insurance premiums.

Moral hazard describes a situation where a person purchasing insurance modifies their behaviour because they do not bear the full cost of the consequences of their actions, again raising the expected cost of an insurance policy.

These features may cause market failure in the sense that some relatively low risk consumers are either not offered insurance or face high prices. This may arise if insurers cannot sufficiently identify and discriminate between high and low risk customers, and there are too many high risk/cost consumers.

Big Data potentially reduces these information asymmetries and thus the associated market failure. For example, telematics devices enable otherwise high risk drivers to be offered insurance at lower prices, thus addressing issues associated with both moral hazard and adverse selection. These devices can also be used to inform drivers of their bad habits that may increase the risk of accidents, and thus allow them to modify their behaviour. However, as the take-up of telematics devices increases, those young/high risk drivers who do not wish to install monitoring equipment will increasingly be made up of higher risk drivers who will consequently face higher prices and/or find it difficult to secure cover at all.

The Economist succinctly expressed this issue in the following terms:

> "A natural consequence of more precise individual underwriting and pricing is that some risks may stand revealed as being so high that they become uninsurable. In some instances, this seems right: the world's worst drivers may need to be discouraged from taking to the road. In other cases, however, such outcomes would raise hard questions: if people looking for medical insurance have a genetic predisposition to a deadly disease, there is less they can do about it."

However, it is nevertheless important to recognise that information asymmetries do compromise the efficiency of insurance markets with real costs to consumers overall, and that the central function of insurance companies is to price risk. If there were to be a severely disadvantaged (high risk) customer segment and this was deemed a policy issue, then there might be more efficient ways of addressing any such concerns through giving them benefits through the tax system, rather than seeking to prohibit any cost-based

discrimination against them. We would certainly be hesitant in any suggestion that unelected regulators should seek to institutionalise any cross-subsidy in favour of a high risk group of consumers, and we would expect the FCA to be similarly cautious.

A more complex issue is that Big Data is not solely used to assess costs/risks, but also demand in terms of customers' willingness to pay, and the FCA indicates that it wishes to assess the extent to which this is the case. The FCA observes that "there is forthcoming FCA work looking at price discrimination in financial services more generally".

In addition, on 3 December 2015, the FCA published proposals to require general insurance providers to publish details of last year's premium on renewal notices.[21] This is aimed at addressing low levels of consumer engagement and competition when some types of policies are renewed.

In particular, the FCA found that aggregated data from three home insurance providers suggests that premiums increase materially over five years until they plateau. Customers who have been with the same firm for five years pay on average 70 per cent more than new customers. Similar aggregated data was obtained from three motor insurers. The position varied across these insurers, with two firms showing little evidence of average prices increases at renewal. For the other firm, consumers who negotiate prices at renewal reduce their premiums on average by a fifth.

In 2014, the FCA launched a large scale randomised controlled trial with over 300,000 consumers across the UK to test reactions to different types of information provided at renewal and whether this prompted people to switch. The inclusion of last year's premium on renewal notices had the greatest impact, prompting between 11 per cent and 18 per cent more people to either switch provider or negotiate a lower premium when prices sharply increase.

The FCA's press release states that it "is also reminding firms of their obligations to treat customers fairly, and to consider how their approach to renewal pricing in general, and the treatment of long-standing customers in particular, delivers fair outcomes to consumers".

Before proceeding further, it should be noted that price discrimination may be a feature of many competitive markets in that those customers who are price sensitive or who shop around more tend to pay less. This is more generally an issue of behavioural economics and a topic that has been assessed in a number of recent CMA market investigations, including its on-going retail banking investigation. The extent to which any such non cost-based price discrimination raises competition concerns will be influenced by the competitiveness of markets. This issue is considered in the next section.

Does the use of Big Data foster or constrain competition?

Retail insurance markets are generally competitive

Before proceeding further, any assessment of the competitive effects of Big Data should start with considering the competitiveness of retail insurance markets more generally. In this regard, it would seem highly relevant to have close regard to the CMA final report on its investigation into the market for PMI that was published in September 2014.

The CMA found that the PMI market was characterised by low concentration among insurance companies and high levels of consumer switching in relation to PMI in both absolute terms and relative to other products. The CMA also concluded that PCWs had facilitated new entry in PMI as new providers have been able to attract customers by posting competitive prices on PCWs rather than through advertising. The CMA also found that demand was more price sensitive when selling via PCWs than via PMI providers' own websites, phone sales, and renewals. The CMA indicated that this price sensitivity could be expected to depress PMI providers' profit margins.

Whilst the CMA did identify adverse effects on competition relating to the operation of PCWs, the sale of insurance add-ons, and the separation of cost liability from control, these did not relate to the intensity of competition between PMI providers in the supply of basic PMI.

There has been no analogous CMA review of household insurance, but ABI statistics indicate that in 2014 the top five households insurers had a combined share of only 56.9% of gross premiums, which is similar to the combined share of the top five private motor insurers of only 52.0%.[22] Household insurance is similarly widely available from PCWs.

Demand-side factors

The FCA indicates that it is interested in how Big Data affects consumers' ability to compare products and choose the one that is most suitable.

This is, of course, a matter of fact question. However, the development of, for example, motor insurance policies that are linked to telematics devices, has not prevented various PCWs from offering comparisons of different insurers' offers for such insurance.

A further issue raised by the FCA is whether insurers' telematics data is available to other insurers. If this data is not shared, then this could create a barrier to switching as the insurers with the data will have superior information as to that consumer's risk profile. However, these policies often provide summary data to consumers to assist them in understanding and improving their driving habits, and this information could thus potentially be shared with other insurers. In addition, it would seem relevant to consider whether, if data is not shared, insurers are able to derive high profits from such customers, including the cost of any equipment supplied.

Supply-side factors

The FCA acknowledges that Big Data may facilitate new entry by insurers and the development of new products.

However, the FCA also suggests that Big Data may also create barriers to entry relating to the cost of creating and managing predictive models using Big Data, and new entrants could suffer an information disadvantage over incumbent firms. Similarly, insurers selling ranges of retail insurance products may have an informational advantage over monoline insurers, and large insurers over small insurers. However, by definition, Big Data is not necessarily proprietary to individual insurers[23] and thus it may be acquired and used by new and small insurers as well.

These issues are complex as there tends to be diminishing returns to more data, and the benefits of additional data can be expected to be particularly substantial in relation to small, but otherwise high risk market segments.

However, it may be premature to have substantive concerns as to barriers to entry and expansion given that retail insurance markets are generally not concentrated and there are many sizeable insurance companies.

Conclusions – appropriate regulation?

The FCA's call for inputs is, as its title suggests, not seeking to draw conclusions. However, it expressly recognises that "Big Data has the potential to promote substantial innovation in the interest of consumers of retail GI". In particular, there is material scope for Big Data to reduce the information asymmetries that may compromise the efficient functioning of insurance markets. This does not mean that there are no regulatory or competition issues, but that any responses to these issues should not compromise innovation that benefits consumers.

The FCA also rightly recognises that its regulatory framework and a host of data protection rules, including the proposed General Data Protection Regulation, may affect that use of Big Data by insurers. Insurers themselves also face an array of technical challenges in using Big Data efficiently and effectively, and an imperative to overcome these challenges due to the strong competitive pressure they face to offer low priced and high quality policies.

Endnotes

1. "The Economics of Insurance Markets – Challenges and Change", Pablo Florian and Mat Hughes (AlixPartners), ICLG: Insurance & Reinsurance 2015.

2. CMA, "Private Motor Insurance market investigation: Final Report", 24 September 2014. (https://www.gov.uk/cma-cases/private-motor-insurance-market-investigation).

3. FCA, "General Insurance Add-Ons: Final Report – Confirmed Findings of the Market Study", July 2014.

4. Commission Regulation (EU) No 267/2010 of 24 March 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to certain categories of agreements, decisions and concerted practices in the insurance sector (the IBER). Although the current IBER will be in force until 2017, the European Commission launched a consultation on 5 August 2014 to seek the views of stakeholders who have direct experience with the application of the IBER, including insurance and re-insurance undertakings, industry associations, insurance intermediaries, as well as customers and public authorities (http://ec.europa.eu/competition/consultations/2014_iber_review/index_en.html).

5. For a discussion of the impact of behavioural economics on competition investigations see "Gearing Up for The FCA" at http://www.alixpartners.com/en/Publications/AllArticles/tabid/635/articleType/ArticleView/articleId/816/Gearing-up-for-the-FCA.aspx#sthash.01g6I0HW.dpbs.

6. FCA, "Call for Inputs: Big Data in retail general insurance", 24 November 2015, available at fca.org.uk.

7. The competition law implications of Big Data are a topical subject more generally. For example, the British Institute of International and Comparative Law hosted a conference on "The Role of 'Big Data' in Competition and Privacy Law" on 9th September 2015. The authors were amongst the speakers.

8. Available at http://www.investopedia.com/articles/investing/042915/how-big-data-has-changed-insurance.asp.

9. In terms of the precise scope and terms of cover (such as excesses).

10. For example, in the context of so-called pay day loans those who seek quotes for the largest possible loans before settling for smaller loans might exhibit higher default rates than the average customer.

11. The Economist, "Insurance: Risk and reward", "Data and technology are starting to up-end the insurance business", 14 March 2015, available at the Economist.com

12. Available at http://www.cii.co.uk/knowledge/policy-and-public-affairs/articles/big-data-and-insurance-a-conversation/37620.

13. For example, the CII report cites an article from the Wall Street Journal of 25 February 2013 that a US health insurance had bought data on consumer purchases in order to flag health-related actions, like buying plus-sized clothing.

14. The Economist also cites the examples of State Farm, one of America's biggest insurers, which has teamed up with ADT, a home-security company that allows people to monitor their homes remotely. Similarly, the Economist indicates that FitBit, which makes watch-like fitness trackers, now works with a number of insurers and employers who want to keep tabs on their policyholders or employees.

15. For example, people with young families might wish for more accidental damage cover, and the extent of the cover which people wish to purchase may increase as their income rises.

16. ABI press release, "You could not make it up, but they did. Savings for honest customers as insurers expose £3.6 million worth of insurance frauds every day", 13/07/2015, available at abi.org.uk.

17. Due to insurance renewals accounting for about 59 per cent of all PMI policies, PCWs account for 23 per cent of all PMI business.

18. If an insurer sets prices too high, then it will also lose market share. However, it will have no liability associated with policies it has not sold.

19. Available at http://www.ft.com/cms/s/2/21a6e7d8-b479-11e3-a09a-00144feabdc0.html.

20. The problem of distinguishing between correlation and causation exists in an array of contexts. For example, it is entirely plausible that eating a good breakfast helps children perform well in school as this might assist children's concentration and general health (see, for example, http://www.bbc.co.uk/news/uk-wales-34834832). However, it might (or might not) also be the case that children who eat sensible breakfasts are more self-motivated (and sort out their own breakfasts), have more pro-active parents, or otherwise have a better home life, and thus it might be difficult to separate out the benefits of children eating breakfast from other positive factors that are correlated with children eating breakfast. Accordingly, a possible government policy of funding free school breakfasts might have less effect on boosting children's performance than anticipated based on simple correlations.

21. Available at http://www.fca.org.uk/news/insurance-firms-required-to-publish-last-year's-premium. This press release includes links to the FCA's accompanying Consultation paper, which sets out the details of its various related proposals as well, and its Occasional paper setting out its evidence. The Financial Times reported on 3 December that a number of insurers already provide previous premiums on some or all their policies (available at FT.com). The Financial Times also reported that surveys carried out for Which? found that 68 per cent of people said that having last year's premium on the renewal letter would prompt them to look for a better deal with other insurers.

22. ABI General Insurance Rankings 2014, available at abi.org.uk.

23. Some Big Data may be proprietary, such as that relating to telematics devices.

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AlixPartners has a multi-disciplinary practice covering economics, forensic accounting, and information management services (such as e-discovery and applied data analytics). Applied data analytics is routinely applied with economics expertise to improve the performance of enterprises, but also to unlock insights as to customer behaviour, the drivers of costs, and the impact of competition from rivals in the context of competition inquiries.

Members of the AlixPartners team acted in relation to the Competition and Markets Authority's (CMA) recent market investigations in relation to payday loans and private motor insurance, and are acting in relation to the CMA's on-going market investigation into personal current accounts and of banking services to small and medium-sized enterprises. They have also acted in relation to the payment protection insurance market investigation before the Competition Commission and the appeal to the Competition Appeal Tribunal, and in connection with the Office of Fair Trading's WhatIf? Private Motor investigation.