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Economic Review of Proposed Vero - Tower Merger

Prepared for

AIG Insurance New Zealand

economics | research | forecasting | public policy

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Executive Summary

1. Vero Insurance New Zealand Limited ('Vero') has applied to the Commerce Commission for clearance to acquire Tower Limited ('Tower'). AIG Insurance New Zealand Limited ('AIG') has commissioned this economic analysis of the proposal, which represents the independent views and analysis of the author.

Market Structure

2. At the aggregate level across all forms of insurance, New Zealand already has a highly concentrated insurance industry in comparison with other jurisdictions such as USA, UK and Australia. Beneath this average, concentration is even greater in personal lines insurance underwriting in New Zealand. This analysis focuses on the home, contents and private motor vehicle insurance market (HCMV), which represents 90% of personal lines insurance. Table 1 shows that the proposed merger would result 87% of HCMV revenues being earned by the top three firms ("3CR"), with the merged entity accounting for 38% of HCMV revenues.

Table 1: Post-Merger 3CR and Merged Firm Share by Insurance Type

	3CR	Merged Firm
All Insurance	75%	24%
HCMV Insurance	87%	38%

3. As explained below, post-merger, neither of the next two largest suppliers of HCMV insurance would be remotely capable of challenging the resulting two large suppliers. In effect, the proposal is therefore a 3:2 merger.

Pricing Analysis

4. The complete absence of price comparison websites for HCMV insurance in New Zealand is unique among the main comparator countries: USA, UK and Australia. Such websites are so common in these countries that concerns have been raised about whether they have too much market power. Their absence from New Zealand raises the opposite concern: that somehow our more concentrated HCMV insurance sector has blocked the entry of such websites. This concern is reinforced by the reported refusal of IAG and Vero to *"hand their pricing over to online insurance comparison sites"*.

5. There are sporadic attempts in New Zealand to publish price comparisons for motor vehicle insurance. Using the most recent of these, which covers four different vehicles of very different values and two driver ages, we find

   a. Very substantial price dispersion, with the most expensive premiums being around twice the price of the least expensive; and

   b. Tower's premiums generally slightly above the median premium for each car/driver pair.

Unilateral Effects

6. Our analysis of unilateral effects finds that there are substantial barriers to entry in the HCMV insurance sector, including the information advantages held by incumbents and the requirement to hold sufficient capital to secure a comparable financial strength rating. We do not agree that the two recent entries cited by the applicants are relevant because neither is an example of new HCMV underwriting. Nor do we accept that there is any evidence of imported underwriting of HCMV insurance that is sufficient to constrain the merged entity.

7. We also review the prospect of banks exercising countervailing power against the merged entity and find this to be unlikely. On the contrary, the 3:2 nature of the proposal in respect of HCMV underwriting will have the effect of reducing whatever countervailing power banks might currently enjoy.

8. For these reasons, as further explained in the body of the report, we consider that the proposed merger will substantially lessen competition for final consumers of HCMV insurance products.

Coordinated Effects

9. When compared against the list of factors that may make markets susceptible to coordinated effects, the proposed merger falls into three categories. Some factors that will not change as a result of the merger are present, while others are absent. The two factors that will change are:

    a. Elimination of the only independent third supplier; and

    b. Movement to a duopoly of similar sized firms.

10. Both of these will tend to increase the risk of coordinated effects. Moreover, there is historic evidence of coordinated effects, even with Tower as an independent smaller but viable challenger to IAG and Vero. This is the refusal by IAG and Vero to participate in price comparisons noted above (¶4). This fact confirms that the HCMV insurance sector is susceptible to coordinated effects and implies that the removal of Tower as an independent third supplier will increase the risk of such effects.

Systemic Risk

11. Systemic risk refers to the risk that an insurance company will become “too-big-to-fail” so that, in the event of misadventure due to mis-pricing or accident, it will be bailed out by the government. This is a competition problem because the capital markets are unable to effect an orderly restructuring of the insurer, so the government ends up bearing the cost.

12. Buyers of HCMV insurance are also taxpayers, so this is also a default on the contract between insurer and insured.

13. The history of AMI shows that even under a less concentrated market structure than proposed by the merger, firms can be too big to fail. The increased concentration proposed by the applicants will increase systemic risk.

Conclusion

14. For these reasons, and based on the more detailed analysis reported below, we consider that the proposed merger would substantially lessen competition for HCMV insurance in New Zealand.

1 Introduction

15. Vero Insurance New Zealand Limited ('Vero') has applied to the Commerce Commission ('the Commission') for clearance to acquire Tower Limited ('Tower'). AIG Insurance New Zealand Limited ('AIG') commissioned this economic assessment of the proposal, which represents the independent views and analysis of the author. Biographical details of the author are appended.

16. Relevant features of the New Zealand insurance industry are considered in this introductory section. This is followed by a brief review of the Statement of Preliminary Issues (SOPI) issued by the Commission and an outline of the structure of the balance of the report.

1.1 Relevant Industry Background

17. The proposed transaction affects general insurance markets in New Zealand. Suppliers to these markets incurred major claims as a result of the Christchurch earthquakes in September 2010 and February 2011, after which regulations were tightened to standards more common internationally, requiring insurers to be protected (through reinsurance or capital) against a 1 in 1000 year event rather than a 1 in 250 year event.

18. The Christchurch earthquakes exposed one major general insurer to financial difficulties. AMI was reportedly *"New Zealand's second-largest residential insurer"*[1]. Soon after the February 2011 earthquake it sought and was granted a $500m capital facility from the government. Subsequently AMI's distressed earthquake-related book was taken over by the government and the balance of AMI's business was put up for tender. IAG won the tender and the acquisition was cleared by the Commerce Commission in February 2012.[2] At the time, the Commission considered (at ¶3) that

> *"competition from existing domestic insurance companies, coupled with the competitive constraint provided by bank insurance distributors, [was] likely to be sufficient to constrain the merged entity"*

19. General insurance markets were subsequently further concentrated as a result of the exit of a number of insurers. Details were provided in a 2014 submission to the Commerce Commission by Suncorp which identified six of the most important exits since the Christchurch earthquakes. Suncorp said that the reasons for these exits included *"increased… capital requirements … earthquake losses and reinsurance difficulties"*.[3]

[1] http://www.stuff.co.nz/business/money/4856873/Quake-hit-AMI-insurance-bailout-could-cost-1-billion

[2] Commerce Commission Determination Re IAG (NZ) Holdings Limited and AMI Insurance (Operations) Limited, 29 February 2012.

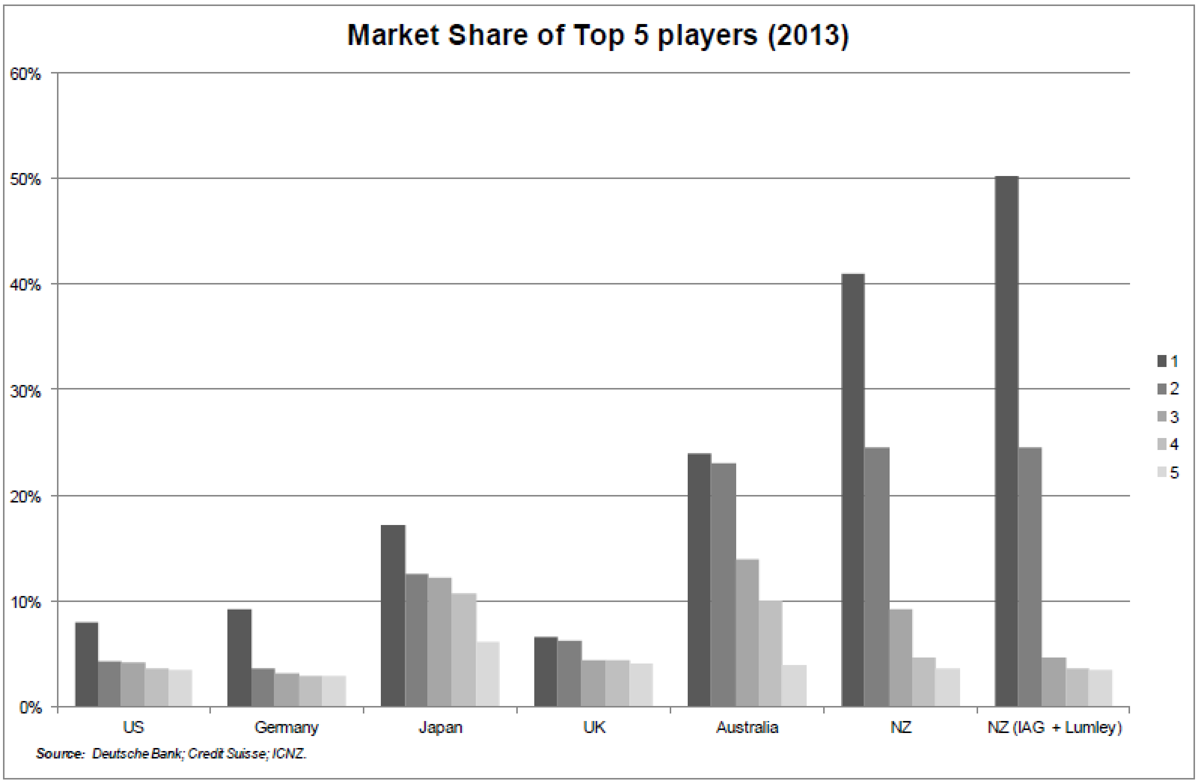
[3] Submission of Suncorp Group Limited on IAG's proposed acquisition of Wesfarmers' underwriting business, 21 February 2014, at p9.

1.1.1 IAG – Lumley

20. The next material change in market structure occurred in May 2014 when the Commission cleared the acquisition of Lumley by IAG,[4] saying that it was "*satisfied that post-acquisition, IAG [was] unlikely to be able to profitably increase prices for personal insurance products above, or reduce quality below the levels that would prevail without the acquisition*". The Commission's conclusion was supported by its view (at ¶12.1) that, though IAG and Lumley both provided underwriting services to banks, two alternative options would remain post-merger, namely Vero and Tower.

21. The Commission considered market share data at the product level but this is redacted from its Determination. However, a public submission in opposition to the merger from Suncorp included an international comparison of market shares if the merger were, and were not approved. This is reproduced as Figure 1 below.

Figure 1: International Comparison of Insurance Concentration (Source: Suncorp)



1.1.2 How the Insurance Industry Works

22. Insurance products rely on the statistical fact that overall risk can be reduced by pooling together a large number of individual risks that are not perfectly correlated. Producers of insurance, known as underwriters, are firms that undertake this risk pooling activity. There are two main inputs into the underwriting function.

   a. A capital base of sufficient size to withstand variation in the expected difference between the flow of revenues (from premium payments) and the flow of costs (from

[4] Commerce Commission Determination Re IAG (NZ) Holdings Limited and Lumley General Insurance (N.Z.) Limited, 6 May 2014.

claims). The capital base of an underwriter comprises some combination of shareholder funds and reinsurance.

b. Data and models of sufficient accuracy to allow the underwriter to make reasonable predictions of the flow of claims, and therefore to set efficient prices for insurance products.

23. Insurance products are distributed, or retailed, through several channels. Some products are sold directly by the underwriter, possibly under different branding. It is also common to use intermediaries to sell insurance products, notably brokers and banks. Intermediaries are resellers of insurance rather than underwriters. In some cases, intermediaries might suggest or request variations in the composition of particular insurance products.

1.1.3 Economies of Scale and Scope

24. While capital inputs can be acquired by insurers in workably competitive markets, the situation is different for the data required by models used to estimate risks and set insurance product prices. As the AIG submission explains (at ¶3.10 – 3.12), the best quality data is derived "in-market" from an insurer's own records. These data are not shared between insurers and the only substitutes are inferior. Without a base on in-market data an insurer needs to set prices on the basis of whatever proxy information may be gleaned from public sources or bespoke surveys. Since the substitutes for in-market data are less accurate, prudent insurers relying on it must recognise higher costs and set correspondingly higher prices for their products.

25. The accuracy benefit of in-market data is expected to be greater for larger insurers. Larger pools of in-market data contain more information about risk than smaller pools. Similarly, larger insurers are likely to achieve greater reductions in overall risk as a consequence of their larger pools of individual risks.

26. There is an empirical literature investigating economies of scale and scope in the supply of non-life insurance but it does not offer conclusive evidence of relevance to the existence of scale or scope economies. Toivanen (1997) cites six such studies and reports typical findings that economies of scale are present up to about $15bn in assets, with either small or no economies of scope.[5] However, one of the papers cited, Suret (1991), finds economies of scale to exhausted at much smaller scales ($100m) in Canada.[6]

1.1.4 Industry Structure

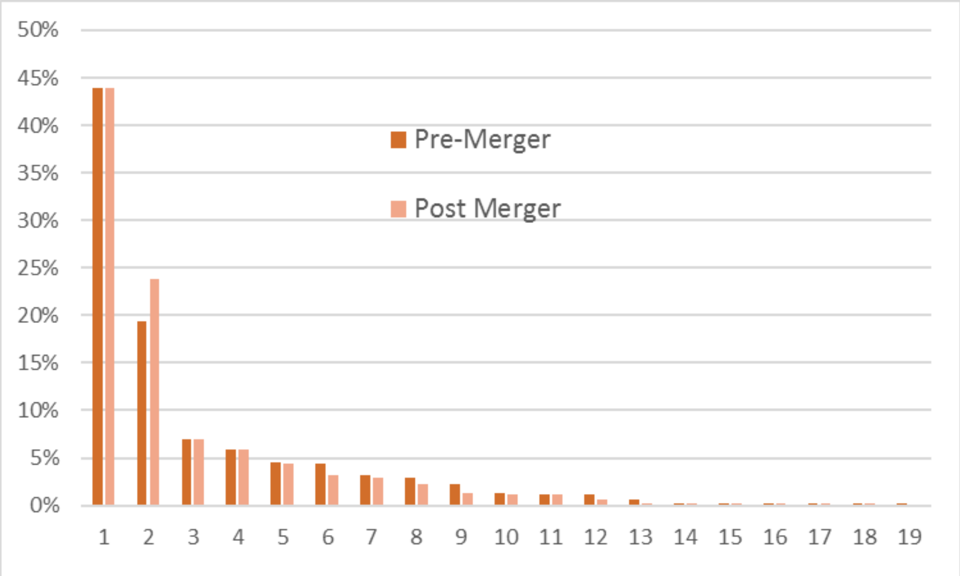
27. The current structure of the non-life insurance industry in New Zealand is very uneven. The two largest non-life insurers (being IAG and Vero) account for 63% of gross written premiums (GWP) and the next largest (QBE) has 7% share. Using 2016 data from the Insurance Council of New Zealand (ICNZ), Figure 2 shows the distribution of market

[5] Otto Toivanen, 1997, Economies of Scale and Scope in the Finnish Non-Life Insurance Industry, Journal of Banking and Finance, 21, pp. 759 – 779.

[6] Jean Marc Suret, 1991, Scale and Scope Economies in the Canadian Property and Casualty Insurance Industries, Geneva Papers on Risk and Insurance, 16, pp. 236 – 256.

shares with and without the proposed merger. The merger would increase the overall market share of the largest two insurers from 63% to 68%.

Figure 2: Shares of GWP in 2016 with and without Merger



28. The aggregate data shown in Figure 2 are not representative of concentration in any particular insurance market, some of which are more concentrated than these averages. So, they understate the *relevant* measures of change in market structure. Nevertheless, even bearing this understatement in mind, the proposed merger falls comfortably inside the range where a clearance assessment is required under the Commerce Commission's merger guidelines. In particular, even at this aggregate level, the post-merger three-firm concentration ratio (3CR), at 75% exceeds the Commission's 70% threshold, and the merged firm would have a market share of 24% which exceeds the Commission's 20% threshold.[7]

29. The applicants cite efficiencies as a rationale for the proposed merger.[8] This indicates that Vero (as the larger of the applicants) is currently experiencing economies of scale. It further implies that the two largest general insurers currently have a cost advantage over all other general insurers and that the merger would increase that cost advantage for the applicants.

1.2 Statement of Preliminary Issues

30. The Commission released a statement of preliminary issues (SOPI) on 16 March 2017. In this section, we respond briefly to the SOPI, including by indicating some additional issues covered in this report.

Market Definition

31. The SOPI appears to accept the applicants' product market definitions, which are the same definitions used by the Commission in assessing the IAG/Lumley merger. Six

[7] Commerce Commission, Mergers and Acquisitions Guidelines, July 2013 at ¶3.51.

[8] Paragraph 5.3 of the Notice seeking clearance, 2 March 2017.

distinct insurance product markets are defined, along with two input markets. We note that the markets as stated embody a customer dimension.

32. AIG has submitted that there is a combined market for domestic house and contents and private motor vehicle insurance, the HCMV market, which would reduce the number of relevant insurance markets to five. We will assess this possibility below.

33. It may also be worthwhile viewing certain interactions between the underwriting and distribution/retailing functions as occurring in a wholesale market. In particular, there may be a distinct wholesale market for the supply insurance products to banks.

Counterfactual

34. We agree with the Commission that an assessment is required of whether the competitive effects of the proposed merger would differ between the two possible counterfactual scenarios: the status quo; and acquisition of Tower by Fairfax.

Unilateral Effects

35. It is necessary to carefully assess the competitive positioning of Tower in all relevant markets, as noted in the SOPI.

36. Additionally, on the demand side, to the extent that countervailing buyer power and/or customer switching options are likely to constrain the merged entity, these should be factored into the assessment.

37. Supply side issues are also potentially relevant, including the potential (and/or barriers to) entry and the expansion of existing smaller insurers.

Coordinated Effects

38. The main structural effect of the proposed merger is to move insurance underwriting to a duopoly structure, albeit with a competitive fringe. Co-ordinated effects analysis should therefore focus on the risk that, post-merger, the two largest firms may engage in parallel conduct to the detriment of consumers.

Systemic Risk

39. AIG has raised a concern about increased systemic risk that could arise from reduced diversification across reinsurers. We will consider this issue from a competition perspective.

1.3 Report Structure

40. In the balance of this report we will

   a. Outline potential theories of harm and draw on these to define markets, in section 2;

   b. Undertake analysis of competitive effects, in section 3; and

   c. Derive our conclusions in section 4.

2 Relevant Markets

41. The purpose of market definition is to expose the underlying competition issues as clearly as possible. It is therefore helpful to begin this section by articulating theories of harm, and then proceed to define markets.

2.1 Theories of Harm

42. As shown in Figure 1, general insurance markets in New Zealand are already highly concentrated by international standards and the proposed merger would materially increase concentration. However the situation is rather more severe for personal lines insurance according to the market share estimates submitted by AIG. In respect of the main insurance products in this category (home, contents and private motor) the proposed merger is effectively a 3:2 merger at the underwriting level.

43. It also appears that there are significant barriers to entry and expansion in respect of personal lines insurance underwriting, in which case a merger to duopoly would have long-lasting effects on competition. The first theory of harm can therefore be described as being

> *That the merger would substantially and durably lessen competition between underwriters of home, contents and private motor vehicle insurance.*

44. Bearing in mind the same concerns over the effects of a 3:2 merger on competition for personal lines insurance, and the importance of banks as distributors of these products, we might for completeness include a distinct but closely related theory of harm:

> *That the merger would substantially and durably lessen competition in the wholesale markets for the provision of home, contents and private motor vehicle insurance to banks.*

45. Both of these theories of harm could be broken down further, for example to reference specific ways in which competition might be lessened, but these matters sit more naturally in section 3.

46. As discussed in section 1.1 above, there are sound reasons to expect that the cost of providing insurance falls with scale and the applicants expect to achieve cost efficiencies. In a small market like New Zealand, this might raise a question about whether a monopoly insurer might have the lowest costs of all possible market structures. Offsetting any such efficiencies, competition authorities recognise that as concentration increases so does the risk of market power being exercised to the detriment of consumers.

47. In the case of insurance markets, however, consumers face an extra risk from increased market concentration: the cost of errors and accidents may increase. That possibility arises from the fact that all insurance pricing reflects estimates of risk, which by definition are not perfectly accurate. Under-pricing risk, for example to attack and potentially exclude smaller competitive rivals, can result in the financial failure of an insurer, as the post-earthquake experience of AMI has shown. From a consumer perspective, competitively aggressive under-pricing of risk is of minimal concern if it is undertaken by one of many small insurers, because competition in the capital markets will be able to manage the

orderly restructuring of any insurer that fails as a consequence of under-pricing. However, in a duopoly structure, even with a competitive fringe, this is much less likely to be feasible for either of the duopolists. This leads to the third theory of harm.

> *That the concentration of risk arising from the new market structure may exceed the ability of capital market competition to effect orderly restructures of the two largest insurers.*

48. We will consider this theory below, including whether it can reasonably be characterised as a competition problem.

2.2 Personal Lines Markets

49. The question addressed in this section is over the delineation of markets for the main personal lines insurance products. The applicants submitted, and the Commission did not query in its SOPI, that there is a market for house and contents insurance, and a separate market for private motor vehicles. AIG's submission argues that these are combined into a single HCMV market, which would be a cluster market.

50. The relevant economic questions are therefore about the prevailing mode of competition and whether an insurer supplying just one of these two components could compete effectively against rivals supplying both. In assessing these questions, we will emphasise the importance of underwriting rather than the distribution of insurance.

51. A review of the websites of major distributors of personal lines insurance in New Zealand found multi-policy discounts were offered in all cases. Some were explicit about the size of the discount; others required a specific inquiry. The information offered is summarised in Table 2.

Table 2: Discount Information Offered by Insurance Providers (9 June 2017)

Retailer	Discount Offers
State (IAG)	15% for House + Contents. Further 10% for multi-policy
Tower	20% for 3 or more policies
NZI (IAG)	Discounts for 2 or more policies
AMI (IAG)	Discounts for 2 or more policies
ASB (IAG)	Package discount for HCMV
BNZ (IAG)	Package discount for car and another type of PremierCare general insurance
ANZ (Vero)	up to 15% discount for 2 or more policies
Westpac (IAG)	10% discount for car and home

52. Although not all distributors stated a level of discount, the fact that some do indicates that anyone shopping around would use the stated range of discounts (10% - 20%) as a guide for comparison with the discounts discovered through a direct inquiry. It seems clear that bundle discounts are the norm in this market, so that competitive positioning will focus more on other features of the insurance offered, particularly the premium and the excess.

53. On the demand side, there will be some people who do not own, and hence will not demand insurance for, all three of home, contents and motor vehicle. For example, people living in rented accommodation may purchase contents insurance alone, or contents and vehicle insurance. Consequently, none of the HCMV bundles are fixed; consumers are free to unpick them and omit some items. Similarly, there will be consumers wanting to add insurance for a second vehicle to their bundle. Such variations do not dispose of the possibility of a cluster market however: if they did, there could not be a distinct market for "house and contents" insurance.

54. There are some brokers selling vehicle insurance alone. Some of these are serving niches within the vehicle sector, such as ClubAuto (underwritten by Tower) which specialises in insurance for modified and high-performance vehicles. Others, such as AutoSure (underwritten by Vero) appear rather broader.

55. We have not found any brokers selling house insurance alone. It therefore seems that, *at the distribution/retail level*, the question of whether there is a HCMV cluster market depends on which product is used to examine the stand-alone test.

56. More importantly, the proposed transaction raises most competition concerns at the underwriting level, not in the distribution of insurance. Our review of the motor insurance distribution sector suggests that these products are primarily underwritten by either IAG, Vero or Tower. Accordingly, in what follows we will refer to a HCMV market.

3 Competition Analysis

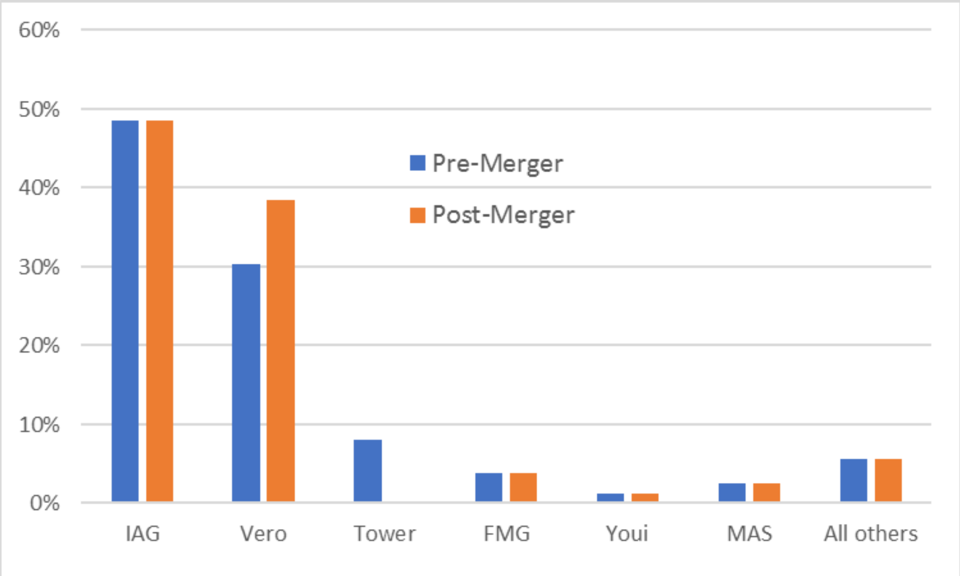
57. This section starts with a review of market structure information and proceeds to consider the likely unilateral and co-ordinated effects of the proposed merger. Systemic risk issues are then analysed.

3.1 Market Structure

58. Due to aggregations in the data provided to the public by ICNZ, some estimation is necessary to identify the size and share of relevant markets. In particular, ICNZ reports commercial and private motor vehicle insurance as a single category, whereas the applicants and (in previous decisions) the Commission separate out private motor vehicle insurance from commercial. In this section I rely on the data and estimates submitted by AIG to focus on the relevant competition issues.

59. Approximately 90% of personal lines insurance falls into the HCMV category, with the remaining 10% being split between earthquake levies, travel insurance and boat insurance. Concentration within HCMV is greater than for the total insurance market (depicted in Figure 2 above). Estimated pre- and post-merger market shares are shown in Figure 3. Tower is comfortably the third largest firm in this sector. We understand that the "all others" category is diverse and includes the provision of capacity (which is a form of risk sharing) in collaboration with larger insurers.

Figure 3: Estimated Pre- and Post-Merger Shares of HCMV Insurance Market (Source: AIG)



60. Focusing on the HCVM sector, rather than total insurance, also materially changes the summary statistics used in the Commission's merger guidelines, as shown in Table 3.

Table 3: Post-Merger 3CR and Merged Firm Share by Insurance Type

	3CR	Merged Firm
All Insurance	75%	24%
HCMV Insurance	87%	38%

Minor Insurers

61. FMG is primarily focussed on rural insurance, where there is some demand for HCMV insurance, but an understanding of rural environments is also desirable from a buyer perspective. New Zealand is a highly urbanised country: data from the United Nations reports that 86.3% of New Zealanders lived in urban areas in 2014. The prospect of FMG seriously expanding to the extent that it might challenge the largest firms in the HCMV sector are very remote.

62. The Commission will be familiar with Youi, a recent entrant to this sector which has struggled to earn profits and remains very small even several years after entering. Youi's experience suggests that *de-novo* entry into HCMV insurance is very difficult.

63. MAS also provides limited constraint on the three largest HCMV insurers. MAS began by targeting medical professionals and has since broadened slightly, However the constraint of membership limits the scale of MAS and hence its ability to compete directly with the big three HCMV insurers.

64. All insurers in the "others" category are even less able to constrain the big three. This group includes providers of HCMV insurance to private client groups (PCGs) and firms that specialise in a single product, such as BMW cars.

65. Given the very modest size of the smaller firms in the HCMV sector it seems reasonable to describe the proposal as a 3:2 merger that would remove the primary competitor to the two largest firms. If we removed insurers that offer no material constraint on the three largest HCMV insurers from the data shown in Figure 3 and Table 3, the pre- and post-merger concentration indicators would be even more extreme, as would the impact of the merger.

3.2 Unilateral Effects

66. It is helpful to begin the unilateral effects analysis by reviewing how competition works currently, again with a focus on products in the HCMV sector which is where the primary concerns lie.

Price Comparisons

67. The first point to note is that HCMV insurance price comparisons are more difficult in New Zealand than in other markets due to the absence of price comparison websites which are a major feature in other countries. For example, The Economist reports that "*in the British car-insurance industry, about a quarter of all sales, and more than half of new business, flows through them*".[9] In the USA, there are multiple sites available including insurance.com and autoinsurance.org. Several sites also operate in Australia, including comparethemarket.com.au and iselect.com.au. By contrast, it is reported in New Zealand that *"IAG and Vero refuse to hand their pricing over to online insurance comparison sites"*.[10]

[9] The Economist, Costly Comparison, 9 July 2015.

[10] Rob Stock, Shop around for insurance and chop the cost, Stuff.co.nz, 27 April 2015.

68. The absence of HCMV insurance price comparison websites in New Zealand cannot be attributed to the size of New Zealand's economy, because we are well served with other comparison websites, such as for hotels, travel and consumer goods. Moreover, there are price comparison sites for non-HCMV insurance in New Zealand, such as insureme.co.nz which provides quotes on life insurance and health insurance, and bizcover.co.nz for professional indemnity and public liability insurance.

69. It seems reasonable to conjecture that our unusually concentrated insurance markets (as reflected in Figure 1) may help to explain this absence. We return to this point when discussing co-ordinated effects below.

70. For completeness, we note that there have been concerns expressed about the downstream effects of price comparison websites, including in the Economist article cited above and in The Telegraph.[11] Recent work by Endleman and Wright (2015)[12] has shown how these websites can become too powerful, to the point where the consumer benefits of extra price comparisons become negative. Notwithstanding these points however, the complete absence of price comparison sites for insurance in New Zealand is an indicator that competition is already less healthy than desirable.

Price Dispersion

71. When prices can be readily compared and competition is healthy, switching and potential switching by consumers should reduce the dispersion of prices. This effect is sometimes referred to as the law of one price. Since insurance contracts can vary in many dimensions that affect the cost of supply and the value of the contract to consumers, care is needed to ensure like-for-like comparisons.

72. The best comparison we have found for New Zealand is reported by interest.co.nz.[13] It reports premium for ten retailers of insurance, for each of four well-defined cars and two ages of driver (30yrs and 50yrs). The cars range in value from a $2000 Honda Civic to a $74,000 Audi A4. The dispersion in premiums is shown in Figure 4.

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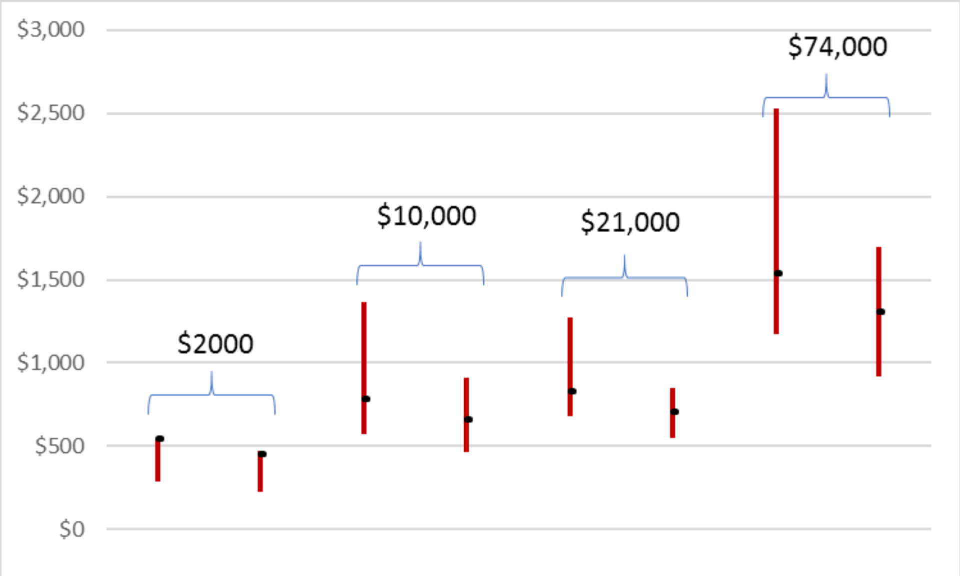
[11] James Daley, Are price comparison websites too powerful? Telegraph.co.nz, 12 June 2014.

[12] Benjamin Edelman and Julian Wright, 2015, "Price Coherence and Excessive Intermediation", Quarterly Journal of Economics, 130, pp.1283 – 1328.

[13] https://www.interest.co.nz/insurance-data/car-insurance-compared-january-2016

Figure 4: Price Dispersion for Insurance on 4 Cars, Drivers Aged 30 and 50 (Source: interest.co.nz)



73. The position of Tower's premium is indicated by a black dot within each of the ranges shown in Figure 4. Tower is relatively expensive for the cheapest car. For the other three cars Tower appears towards the lower end of the range.

74. Interestingly, however, with one very minor exception, Tower's premium is *above* the average premium in each range for these three cars. The average is therefore well below the median for each range, indicating that these premium distributions are skewed: more premiums are below than the median than above it. This suggests that a small number of insurers are opportunistically setting relatively high prices. Tower is not one of these insurers.

75. For each of these eight sets of insurance premia, we calculated the ratio of the highest premium to the lowest. The results are reported in Table 4.

Table 4: Price Dispersion Indicators for Car Insurance

Car Value	Driver Age	Highest/Lowest Premium
2000	30	1.9
2000	50	2.1
10000	30	2.4
10000	50	2.0
21000	30	1.9
21000	50	1.6
74000	30	2.2
74000	50	1.9

76. Some of this dispersion may be accounted for in differences across the policies, the main features of which are reported by interest.co.nz. However, when Rob Stock (footnote 10) reviewed the same sector he reported: *"…I read all the policy documents. I found the*

differences modest". Regarding the relationship between premiums and excess, he found a *"lack of correlation between the excess I was expected to have and the premium"*.

77. Price dispersion can also be an indicator of market power however. In the airline industry, for example, price dispersion has been found to be positively associated with market share.[14] The above data are consistent with this view, since underwriting in the HCMV sector is highly concentrated in New Zealand. For completeness, we note that there are challenges in the literature to the suggestion that price dispersion is a reliable indicator of market power, notably Levine (2012)[15], which assumes that market power will always reduce output, rather than extract consumer surplus without reducing total demand.

Barriers to Entry

78. There are significant barriers to entry in HCMV underwriting in New Zealand, including for the reasons explained in AIG's submission. The experience of Youi shows how difficult *de novo* entry is, even for a firm with an innovative business model..

79. In assessing barriers to entry, it is important to distinguish between underwriting, where extra concentration is proposed, and distribution/retailing where it is not. The applicants appear to argue underwriters can *"easily overcome barriers to entry and expansion"* in respect of personal lines of insurance. However, neither of the two examples cited by the applicants provides any real support for that view.

    a. Lifetime describes itself as a *"full-service financial advisory practice"*. It is primarily focused on financial management, and while it does offer HCMV insurance, it appears to be a distributor of NZI's products rather than an underwriter.

    b. DPL's entry into the motor vehicle insurance sector is also at the distribution level, not the underwriting level. In its statement to the NZX, Turners (the owner of DPL) explained that it would be selling motor vehicle insurance under several brands *"all underwritten by Suncorp New Zealand's intermediated general insurance provider, Vero"*.[16]

80. The lack of evidence of entry or expansion in the HCMV sector is consistent with the submissions Suncorp made in opposition to the IAG-Lumley merger. Key points in these submissions included:

    a. The high levels of penetration, and hence low expected growth, of personal lines insurances in New Zealand; and

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[14] Alberto A. Gaggero and Claudio A. Piga, 2011, "Airline Market Power and Intertemporal Price Dispersion", Journal of Industrial Economics, 59, p.552 – 577.

[15] Michael E. Levine, 2012, "Price Discrimination Without Market Power", Yale Journal on Regulation, 19, pp.1 – 36.

[16] Turners Limited Company Announcement (21 November 2016). Accessible at: www.nzx.com/files/attachments/248544.pdf.

b. The substantial information advantages held by incumbent underwriters, partly as a result of the Canterbury earthquakes.

81. Both of these points made by Suncorp also raise doubts as to the competitive relevance of import competition in the underwriting function, to which the applicants (at ¶6.36) say there are "*few barriers*". We trust that the Commission will be able to assess the size and potential for expansion of foreign-underwritten HCMV insurance in New Zealand.

Countervailing Power

82. The proposed merger is likely to material reduce the countervailing power of insurance distributors. This is most obvious for banks, who currently have three potential providers of white label HCMV insurance products. Post-merger, banks would have only two sources of supply for these products, and for the reasons discussed above (¶78 - ¶81), no realistic prospect of another independent supplier emerging.

83. The presence of Tower as a smaller independent underwriter of HCMV insurance does offer genuine choice to banks. As the AIG submission explains, while any aspiring entrant into HCMV underwriting would *want* to secure a wholesale arrangement with a large bank in New Zealand, for rational and prudent reasons the banks have strict criteria for underwriting providers. Entry to HCMV underwriting via a bank deal has never occurred in New Zealand and this is unlikely to change.

84. One way to view the prospect of removing Tower as a viable third option is to recall the history of mobile telecommunications in New Zealand. Consumer benefits increased materially after 2degrees entered[17] because, even with modest market share, it offered a feasible alternative to the former duopolists, which increased the countervailing power of end-users. It is difficult to imagine that the Commission would readily countenance a merger that shifted this market back to a duopoly.

Effect of Merger on Consumers

85. Final consumers are the indirect beneficiaries of competition between underwriters to supply white label HCMV insurance products to banks. Since banks would have substantially less countervailing power post-merger, consumers will be correspondingly worse off.

86. The expected substantial reduction in competition experience by banks is likely to be mirrored in the direct and broker retailing channels, because

a. buyers in those channels will experience the same reduction in countervailing power as the banks; and

b. competition between banks and other retailing channels will transmit the lessening of competition horizontally to those other channels.

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[17] While we disagree with some of the methods used in this study and with the size of the effects reported, this Venture Consulting report on the economic impact of 2degrees entry is directionally correct: http://www.stuff.co.nz/business/industries/5732458/2degrees-report-finds-big-impact

87. In summary, the proposed 3:2 merger in underwriting HCMV insurances will substantially lessen competition for all final consumers of such insurance, whether they buy direct or through intermediaries.

3.3 Coordinated Effects

88. Some features of HCMV underwriting suggest that this activity is not susceptible to coordinated effects: products are differentiated rather than homogeneous and, partly as a consequence, comparative prices are not always readily observed. Other features do point towards a risk of coordinated effects, such as low levels of innovation, stable demand and repeated interaction.

89. None of the above factors will change as a result of the proposed merger however. The factors that will change are:

    a. Elimination of the only independent third supplier; and

    b. Movement to a duopoly of similar sized firms.

90. Both of these changes increase the risk of coordinated effects. It is known from the experimental literature[18] that competitive outcomes can differ significantly between 2-firm and 3-firm markets, which is consistent with the observations from the New Zealand mobile telecommunications sector (¶84).

91. As noted by Woodbridge/ACCC (2012)[19], another relevant factor is whether there is a history of successful coordination. Any history of this nature would indicate that *"in the past firms in the market have overcome the difficulties in successfully coordinating their conduct, [and] may indicate that the threat of entry is insufficient to prevent successful coordination"*.

92. There is evidence of successful coordination between IAG and Vero in respect of HCMV insurances: their common decision not to supply price comparisons as noted above (¶67). This occurred despite the presence of Tower as an independent supplier to these markets.

93. An independent Tower has unambiguously made coordination more difficult, particularly since it is much smaller than IAG or Vero. This size difference gives Tower a strong incentive to capture market share, by differentiating its overall service to that of its two larger rivals. It is apparent, for example, that Tower *was* willing to supply data to a price comparison website, but the whole project failed because the two largest firms both refused to supply.

94. In a less concentrated market, such refusal would have been much less likely. Suppose, for example, that there were four HCMV suppliers of roughly equal size. Absent explicit collusion, each insurer would have a strong incentive to supply a price comparison website, since none would want to be the only insurer not "on board".

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[18] See the content of, and references cited by, Richard Collins and Katerina Sherstyuk, 2000, "Spatial competition with three firms: An experimental study", Economic Inquiry, 38, pp.73 – 94.

[19] http://www.internationalcompetitionnetwork.org/uploads/library/doc824.pdf

95. By contrast, under the current HCMV structure in New Zealand, IAG and Vero were somehow able to reach a common position to refuse to supply the required information, despite knowing that if Tower plus its main rival were to agree, it could be locked out of a valuable marketing channel.

96. This is a coordinated effect that occurred *with* an independent Tower. It therefore seems clear that, given the current market conditions in New Zealand, the HCMV insurance sector is susceptible to coordinated effects. The consequences of clearing a merger that would remove the major constraint on coordination are therefore likely to be substantial.

3.4 Systemic Risk

97. Mergers do not normally raise questions about systemic risk, but systemic risk does increase with structural concentration in the financial sector, as discussed recently by a senior executive of the Bank of England.[20] In the matter at hand, the relevant question is whether the proposed merger increases the likelihood of a government bailout of an insurance company. If so, this would indicate that efficient competitive interactions in the capital markets, which are normally relied on for an orderly restructuring of failing firms, may be insufficient to cope with a failed insurance company.

98. In such circumstances, an insurance company becomes "too big to fail" and government finances are required to protect consumers. Given the close correlation between taxpayers and final consumer of insurance, the net effect of such bailouts is that final consumers are the ultimate bearers of risk, despite their purchase of insurance products. Such outcomes represent a failure of competition to the detriment of consumers.

99. There is recent evidence of this occurring in New Zealand. After the large HCMV insurer AMI failed, its loss-making policies were taken over by the government while IAG acquired its profitable lines of business. This failure occurred in a materially less concentrated HCMV market than we have today in New Zealand. Since it occurred, IAG in particular has become much larger, through its acquisition of AMI's profitable insurance book, and its subsequent acquisition of Lumley.

100. The unusual nature of the events that gave rise to AMI's failure could easily re-occur, whether by earthquake or through the acute or chronic effects of climate change (such as flooding and sea inundation respectively). The current susceptibility of HCMV markets in New Zealand suggests that further increases in concentration will increase systemic risk. This view is reinforced by the fact that Tower is currently viable as a stand-alone rival to the much larger Vero and IAG, and there are reasonable prospects of it being acquired by parties other than Vero or IAG in the counterfactual. If the merger proceeds, however, it will increase the probability of a too-big-to-fail event.

[20] Andrew G. Haldane & Robert M. May, 2011, "Systemic risk in banking ecosystems", Nature, 469, pp. 351–355.

4 Conclusions

101. This report has focused on the HCMV sector. While there are brokers who specialise in motor vehicle insurance only, the competition concerns in this matter are with underwriting. For the reasons explained above, we consider that HCMV is a distinct market..

102. The HCMV sector represents around 90% of all personal lines insurance sold in New Zealand. At the underwriting level, there are three main suppliers, which the proposed merger would reduce to two.

103. Based on our analysis of price comparison opportunities, observed price dispersion in the motor vehicle insurance sector and countervailing market power, we consider that the proposal would substantially reduce competition for final consumers.

104. Even with the current market structure, there is evidence that the Vero and IAG have been able to coordinate on a refusal to supply price comparison websites, which are common in less concentrated markets such as the USA, UK and Australia. The proposed merger is expected to increase the risk of coordinated effects.

105. The government bailout of AMI, which was a moderately large HCMV, underlines the systemic risk of concentration in this sector. This was a failure of capital market competition, the costs of which were borne by mass market insurance customers through their status as taxpayers. The proposed merger is expected to increase systemic risk.

106. For these reasons, and based on the more detailed analysis reported above, we consider that the proposed merger will substantially lessen competition for HCMV insurance in New Zealand.

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John applies the tools and techniques of economics to issues at the boundary between public policy and private business, and on either side of that boundary.

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