PUBLIC VERSION

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APPLICATION FOR CLEARANCE BY VERO TO ACQUIRE TOWER

1) I have been instructed on behalf of AIG in respect of the application by Vero for clearance to acquire Tower. AIG is troubled that the submissions made by Vero in support of its application, particulary its recent cross-submission response to AIG's submission on the application, are presenting an inaccurate picture of how the relevant markets, and competition within them, operate.

2) As a result, any decision which proceeded on the basis of the Vero submissions would be flawed.

3) In short (elaborated below):

   a) The market has not changed in relevantly material ways since *IAG/Lumley* to support the contradictory submissions now made by Vero contrary to its position then. Moreover, the entry story presented, that it is relatively straightforward and illustrated by Youi and QBE (and MAS and FMG), does not reflect market reality and contains significant inaccuracies.

   b) An argument based on countervailing power (by consumers and, it is said significantly, by banks with tenders over white label products) is only as good as the effective choice available to those said to be able to exercise countervailing power by moving elsewhere. That choice and ability to exercise countervailing power will be significantly diminished in the HCMV market if this acquisition proceeds.

   c) There is a more competitive counterfactual (which Vero seek to downplay). In any case, the proposed acquisition will remove the only current meaningful competitor to Vero and IAG from the HCMV market.

Vero inconsistency

4) The Vero cross-submission had no real answer to AIG's entirely accurate observation that Vero's position in respect of key points now is diametrically opposed to its position three years ago when it sought to oppose the *IAG/Lumley* acquisition. While it is appropriate for the Commission itself to adopt a stance that it is not bound by its former approaches necessarily, consistency is an important hallmark of sustainable decisions. There would need to be very clear and supportable reasons (which AIG has demonstrated there are not) for the Commission to accept now the views of an applicant which took a different position before the Commission so recently, otherwise the Commission's own decision risks becoming flawed.

   a) **The transaction will result in highly concentrated markets, and entry is difficult.**

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i) Patently, it will concentrate the HCMV market substantially. And this is, contrary to the Vero cross-submission, a three to two merger. The substance of this proposed acquisition is not about commercial and consumer products combined. Rather, the issue at hand is the concentration of the HCMV market, and which is comprised of IAG, Vero and Tower as first, second and third. In the HCMV market, the acquisition will substantially exceed the Commission's concentration indicators. Vero's claim in its cross-submission that the transaction makes little difference to that calculation is wrong, and appears to be based on the figures for the combined general insurance market, which obfuscates the effect.

ii) Vero's cross submission attempts to characterise QBE as the "number 3 player" in its assertion that this is a merger of "number 2 (Vero) and number 4 (Tower)". Whilst this is correct when talking about "commercial and consumer products combined", using ICNZ premium rankings, it is incorrect when looking at the consumer market, (and specifically HCMV). QBE does not have a material HCMV book (estimated by AIG to be less than Youi). QBE's position in New Zealand is primarily that of a commercial insurer.[1]

iii) Furthermore, Vero seeks to downplay the accretive effect of the proposed merger and instead talk up the number and market share of the remaining small and mostly niche players in the HCMV market, individually and collectively. AIG stands by the statement that Vero and Tower have a stronger market share than the combined market figures indicate. The ICNZ premium information remains a good indication, however it does not follow that insurers reporting a share of HCMV premium are in fact meaningful competitors or constraints on IAG, Vero or Tower. To be meaningful competitors or constraints they must be able to step into the shoes of the major players and compete like for like. That is, they must have systems, resources, people and capital to assume the role of a primary provider of HCMV, or at least the barriers to establishing these are not high. In the current market, and for the foreseeable future, there are simply no other material participants in the HCMV market. Whilst some insurers have small books of high end house/contents (AIG and Chubb), small books of private motor (Allianz and QBE) or provide capacity to schemes, they are not in a position to compete or constrain IAG, Vero or Tower. It follows that when the ICNZ premium numbers are adjusted to strip out these, the true market share of IAG, Vero and Tower in the HCMV market increases. As this premium data is confidential to insurers, AIG cannot articulate the precise effect, but rather simply notes that in competition terms, Vero and Tower's market presence in HCMV is in fact greater than the ICNZ premium numbers would suggest.

iv) On any view of it, the acquisition will remove a significant competitor in HCMV - Tower. Tower is the only viable constraint on bank white label HCMV and the only insurer that has the infrastructure and underwriting knowledge to materially compete in the mainstream HCMV market. It is not enough to say that the market was already concentrated by virtue of *IAG/Lumley* and this is only incremental, that by making Vero bigger vis-à-vis IAG, competition will be improved (that duopoly is fine) and that AIG is wrong to say there will be no other competitors with more than 3% market share because one (in Vero's view: FMG) will have 4% (all of whom Vero says can expand in any event). Further, Vero's attempt to blame the concentration of the market on the *IAG/Lumley* and *IAG/AMI* transactions is misconceived, as the proposed transaction will substantially increase market share in the HCMV market, as demonstrated in AIG's submission.

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[1] Refer paragraph (a)(viii) below for further discussion and Appendix 2.

v) Vero's cross-submission attempts to claim that AIG was seeking to establish a test stronger than the Act for clearance. This is not correct. But when such a structural concentration is being embedded by an acquisition, far exceeding safe harbours, the Commission must be "satisfied" that it would not be "likely" to have the effect of substantially lessening competition. Recent cases illustrate the care needed in applying those standards. Relevant to being "satisfied" are also other factors such as the point made by AIG about systemic risk - effectively relying on two large insurance companies only to have "got it right" when the next natural disaster strikes New Zealand (because AMI did not, as revealed by the Christchurch earthquake).

vi) The refuge, or fallback, in the face of such concentration can only be that ease and likelihood of entry will constrain the result. Complete new entry is highly unlikely (but the application nonetheless faintly refers to two minnows, Lifetime and DPL, as apparently realistic new entrant constraints, which only serves to underline the hollowness of the submission in that regard). In the case of DPL, they do not underwrite home or content, and nor do they underwrite motor. Rather, they act as a distribution for Vero in respect of motor (as it complements their other offerings) and Vero of course offer home and contents. Lifetime underwrites a different personal lines product all together and is of no relevance to the discussion. What the applicant relies on is an assertion that new entry into HCMV would be "especially straightforward" by an international insurance provider, or there would be expansion by an existing insurer.

vii) As the AIG submission demonstrated, neither of those propositions hold up. First, AIG is an example of an "international insurance provider", also operating in Australia, and it has been unwilling to attempt entry primarily because of the dominance of IAG, Vero and Tower and the barriers to entry previously noted. Unless there is a realistic prospect of acquiring a scalable market share, the costs and risks of entry are a major deterrent to entry and expansion in the HCMV market. Vero's assertion of entry in this way is not supportable, and AIG should know.

viii) Second, Vero points to Youi and QBE as illustrating how expansion can be successful. Those are not reliable examples, because as AIG has shown in its original submission (and indeed Youi by its own submission has independently confirmed) establishment and growth are difficult, expensive and require a long term view. Youi currently has only circa [ ]% market share of HCMV (assuming the Commission considers Youi's products as comparable with IAG, Vero and Tower) and remains unprofitable. Its market share has not materially changed from 2015 to 2016. It remains a start-up operation. The statement by Vero that it "considers Youi may become even more of a constraint as more consumer purchasers begin to occur online"[2] is contrary to Youi's actual performance and remains entirely speculative with no supporting evidence. In the case of QBE (which operates a branch of QBE Australia), there has not been any meaningful expansion or growth in HCMV. AIG's understanding is that QBE does not offer HCMV direct to consumers. QBE have replaced Allianz on BMW (a very narrow distribution point) and in recent time offers home and content through Aon and NZ Brokers Group but which has had very limited take up. The year on year ICNZ premium information does not indicate any diminution in premium between IAG, Vero, Tower and QBE which would support Vero's assertion that QBE is a material competitor in HCMV.

ix) Vero assert that banks are likely to switch underwriters of white label insurances and therefore have significant countervailing power. AIG, as a large international insurer with extensive relationships with banks, and many other distribution points, is well

[2] See paragraph 17, Vero cross submission.

qualified to comment on how bank tenders are secured. By way of example in the New Zealand market, AIG has provided credit card travel insurance programmes through Westpac, ANZ, BNZ in recent years and has tendered on others and renewals of those programmes. As such, AIG is well qualified and able to compete for white label travel insurance. However, underwriting white label products with a bank's parent or affiliated company in another market (which in the New Zealand banking context is limited to Australia) does not translate into a willingness of a New Zealand domiciled bank (which is statutorily bound to act independently from its parent) to switch underwriting. Bank programmes are driven by the proven ability and capacity to deliver within the local market. Where insurers operate in both the New Zealand and Australian markets, tenders can sometimes be further limited to insurers who can provide the relevant product in both jurisdictions – effectively knocking out local insurers in favour of international insurers. However the requirement to have the proven ability and capacity to deliver within the relevant local market remains. As can be seen from AIG's submission, there simply are no other insurers in the New Zealand market that could seriously tender for a HCMV white label product and nor would any insurer scale up infrastructure and resource in advance of securing a bank programme.

x) An argument based on competition between bundled and unbundled products/services may appear attractive in theory, but Vero's explanation at paragraph 9 of its cross submission is not reflective of market reality. Of course, people who own a car but not a house, will seek only motor vehicle insurance and will be priced accordingly for a single product. Equally, when someone purchases a house, they will look to obtain insurance for the house at that time, possibly with the insurer who covers their car or current House (if they have one), possibly a competitor – but this is largely irrelevant to an analysis of the HMRC market. This is because the vast majority of transactions are not about new purchases of houses and/or cars as Vero attempts to make out. Rather, it is the renewals and insurances incepted for existing houses and cars. It is during this phase in the insurance lifecycle that insurers will seek to insure all of an individual's house, contents and motor vehicle risks, and accordingly will bundle products at favourable pricing/ discounts and which new entrants or competitors need to be able to match. These are the transactions which make up the HCMV market and which is why AIG states that to look at house and content as one market, and private motor as another is not reflective of market reality. It is also why AIG states that to be a competitor or restraint on IAG, Vero or Tower is highly unlikely to be effective if an insurer offers just private motor, house or contents in isolation.

xi) The Commission has previously determined that acquiring knowledge of pricing, risk and claim handling specific to a market could take up to 24 months. AIG believes that this time frame is overly optimistic. These are complex issues and cannot readily be distilled into the submission process, necessitating a broader summary. The two dominant players (IAG and Vero) have a clear advantage over new entrants given the immense amount of data they hold, including pricing of repairs, loss history by area, staff resourcing and internal knowledge transfer, economies of scale obtained through greater market share and cost control knowledge and experience. Outside actuarial support (such as Finity) can be utilised to assist pricing models, but they are not a substitute. Vero asserts that, in any event, training staff and poaching staff in some way addresses this. In AIG's view, this is simply incorrect.

The market has not changed so significantly in the last three years, as compared to the 17 years before that, to justify departure from the statement made by Vero to the Commission in *IAG/Lumley*, as recorded in paragraphs 3.7 and 3.8 of AIG's original submission, that entry is highly unlikely and confined to niche entry. MAS and FMG are examples of that, as

Vero pointed out to the Commission three years ago (see paragraph 3.30 of AIG submission). The competitive effect of that niche position is not to punch above its weight due to, for instance, dairy farmers purchasing rental properties (Vero cross-submission, paragraph 18(a)).

A number of these issues raised by the proposed acquisition would benefit from economic analysis, and AIG proposes retaining Mr John Small for this purpose, but any report will not be ready by the currently indicated decision date of 5 May 2017 (as to which, see below).

b) **Countervailing power will not be effective**

i) Countervailing power is only as effective as the choice the party asserted to possess such power, has available to it. That choice will be diminished significantly by the acqusition if it proceeds, for reasons already set out, and so will any realistic countervailing power as a result.

ii) The exercise of such power by HCMV customers is illusory, and has not been the basis of prior decisions.

iii) The exercise of such power by the banks, through their tenders of white label insurance products is also illusory, because the reality is that only strong established local participants will secure these tenders – namely IAG, Vero and Tower.

c) **The counterfactual is far more competitive**

i) The Commission is aware that Fairfax is a bidder for Tower. Vero downplays this, on the basis that it will simply lead to continuation of the status quo, with Tower being run as a standalone subsidiary. However, that understates the likely impact of ownership by a large offshore entity of this kind (with other businesses similar to Tower around the world), and with significant access to capital, having a portal into the New Zealand market.

ii) [ ]

iii) There is every reason to believe that new ownership of Tower by an international insurer that does not currently play in the New Zealand HCMV market will come with initiatives to improve performance and increase competition.

Conclusion

5) AIG focussed on the obvious issues with the application, in its submission on the SOPI. It should not be taken that there are no other issues, however, and AIG has compiled a table of other matters in the application with which it disagrees (attached at Appendix 1).

6) AIG agrees entirely, however, with what Vero told the Commission three years ago, that IAG/Lumley then represented a "tipping point". That characterisation must be, and is, even more applicable to the current proposal.

7) In light of the further information which AIG has suggested be obtained from brokers, the significant issues taken with what has been presented to the Commission by the applicant (by all submitters) and the proposed commissioning of an economist's report which is not yet available, AIG requests that a conference be held on the application to air the various matters. This industry is an important one for New Zealand consumers, the acqusition would concentrate it yet further and unnecessarily, and the proposal raises significant competition

issues. It is timely and appropriate, for all these reasons, for the Commission to depart from its traditional policy of not holding conferences in relation to clearance applications.

8) AIG would be happy to discuss any aspect of this with you further.

Yours faithfully

Matthew Dunning QC

cc Richard Shine – General Counsel, AIG Insurance New Zealand

Appendix 1.

Paragraph references are to Vero's original clearance submission.

1.9 and 8.19
It is factually inaccurate to group Youi with IAG as Vero's "closest competitor" given Youi's
(i) difference in product;
(ii) minimal market share of circa [ ]% of HCMV
(iii) no material growth from year end 2015 to year end 2016 despite widespread marketing.

1.11
Vero has failed to articulate the introduction of its own in-house repair "network" known as SMART Repairs (motor), parts company (ACM Parts) and home repairs. These in-house facilities exist because of the scalability of Vero's HCMV book and which new entrants will be unable to replicate due to lack of scale. One of the clear benefits of these in-house facilitates is to undertake the repair function at cost, if Vero so chooses. Another is to pick and choose which repair work to handle in-house where there is cost benefit to the insurer. New entrants who cannot replicate this process are invariable faced with higher costs and in turn higher pricing.

5.2(c)
Vero incorrectly assert that "IAG" has introduced a high value customer "policy suite" with Crombie Lockwood and has promoted this to ANZ Bank. We assume this is meant to be a reference to AIG, because the true position is that AIG has presented a high net worth home and content policy to Crombie Lockwood, [ ]. This has not been taken up by ANZ Bank. AIG cannot be characterised as a competitor or constraint on IAG, Vero or Tower for HCMV.

5.2(c) and 8.15(b)
Vero has asserted that QBE has established a personal insurance division, but failed to articulate the substance of what this means. AIG's understanding is that QBE has a recent HCMV product available through Aon and NZ Brokers Group but which has had very limited take up. Also QBE has replaced Allianz as the underwriter for motor for BMW via Crombie Lockwood – but again this is fractional in terms of market share. QBE is effectively servicing a very small HCMV market share. QBE cannot be characterised as a material competitor or constraint on IAG, Vero or Tower for HCMV.

5.2(c)
Vero has asserted that Chubb has started offering personal insurance. This is misleading in that Chubb only offers a high net worth house and content product (houses over circa $2miiliion replacement cost) limited to the Auckland market. It is not a competitor or constraint on IAG, Vero or Tower for HCMV.

6.25
Vero has stated that QBE has been expanding into personal lines over the past 2-3 years. Vero neglects to qualify the true impact of QBE endeavours, which is described above.

6.28 and 6.29
Vero fails to identify that Zurich's involvement in motor is limited to commercial risk only.

6.30
Vero seeks to describe the insurance market as being highly competitive by the statement "there are over 75 insurance companies listed with the Reserve Bank and registered as licensed insurers in New Zealand". The true position is approximately 62 of the 75 are either captives, reinsurers, life, or exclusively commercial. Of the 13 remaining AIG,

(i) Allianz, Chubb, and Zurich do not compete in HCMV and in the case of QBE a minimal offering with minimal penetration.

(ii) FMG, MAS, Youi have been discussed in AIG's submission and are best characterised as niche with little or no countervailing power.

(iii) Holland (Ando) do not currently compete in HCMV. If they elect to proceed with a standalone offering, there is no reason to believe that they will any more successful than Youi at best.

(iv) Tower, Vero(AA), IAG are the primary carriers of HCMV.

Accordingly, the assertion of "numerous competitors" throughout Vero's submission and counter submission significantly overstates commercial reality.

8.1
Vero describes Zurich as a "substantial competitor" – notwithstanding it does not write HCMV. Vero further describes Lumley as a competitor, whereas all parties know Lumley is now IAG. Accordingly "Substantial Competitors" should now read '...such as Tower, Suncorp and IAG..."

8.3
Vero attempts to compare the New Zealand broker market with the Australian broker market – yet fails to recognise the inherent difference in size and diversity of the Australian market versus New Zealand. New Zealand brokers simply do not have the choice of insurers which exist in Australia and therefore brokers' ability to act as a countervailing power is limited to the choice available.

8.13
Please note that the AMI clearance involved IAG and not AIG as stated.

8.15(c)
Vero fails to break down the products lines offered by banks under white label. In the case of AIG, we have not tendered for any white label product across any product line – and certainly not for HCMV. AIG have only tendered on credit card travel programmes – a product line which is not relevant to this proposed acquisition. We do not believe QBE has tendered for HCMV white label either. To AIG's knowledge, no HCMV tenders have come up in recent times and were such a tender to occur AIG would not expect to be invited to pitch and nor would it expect any other insurer other than IAG, Vero or Tower.

8.38
Vero asserts that QBE is a new entrant into the commercial insurance market in New Zealand, but please refer to the QBE website which confirms QBE has been operating in New Zealand since 1890.... Vero also asserts an "understanding" that QBE has taken personal insurance business from it in recent years, but provides no information as to the quantum (vitally important information, which a company normally keeps track of). Suffice to say, there is no suggestion that there has been material diminution in Vero's HCMV book and its year on year ICNZ premium numbers do not indicate any material variance.[3]

8.39(b)
Vero asserts that Holland (Ando) has been particularly active in corporate property and has purchased a 20% share in AIG. However AIG's understanding is that Holland (Ando) has

[3] See Appendix 2

capacity to write only small to medium commercial property risk. The assertion that Holland has purchased 20% of AIG is false.

8.39(c)
Vero again fails to explain that the licensing of QBE in 2015 is a reflection of the change in structure from a subsidiary, QBE New Zealand, to a branch of QBE Australia – it is not to suggest that QBE has suddenly become a new entrant. As stated above, QBE has been in New Zealand since 1890.

8.43(d)
Reference to BMW motor being underwritten by Allianz is incorrect. This is now QBE as explained previously. Furthermore the reference to Westpac Australia's relationship with Allianz fails to advise that Westpac Australia now conducts home and content through its own captive, Westpac General Insurance Company and Allianz now just writes private motor.

Appendix 2.

[ICNZ Member Rankings 2014 -2016]