WHEN THE MUSIC IS PLAYING, YOU HAVE TO KEEP DANCING

The idea that there is this invisible hand at play that brings markets into equilibrium goes back to the days of Adam Smith, the founder of modern-day economics. This thinking was behind the concept of laissez-faire, the favoured policy in the lead up to the 2007-2008 financial crisis whereby governments should interfere as little as possible in the workings of the free market and rely on the market to self-correct. What's clear in hindsight, and a lesson that repeats itself over time, is that there are certain situations where the market cannot be relied on, where the laws of competition and rational choices don't behave the way that simplified economic or actuarial models predict.

Charles Prince, the former Chairman of Citigroup, was infamously quoted in July 2007 in the Financial Times when explaining why his bank persisted in leveraged buy-out deals despite fears of the sub-prime meltdown that, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance".

The analogy is powerful in the context of the life insurance and superannuation industry in Australia. For the insurers and reinsurers, despite having to continually set aside billions of dollars in reserves which impacted returns year after year, the industry continued to write loss making products until the day that the regulator stepped in and called time. Similarly, in the superannuation sector, the world's 4th largest, underperformance and inability to create scale has led to the regulator having to set out mandated performance tests and set a size threshold for continued operation of funds. In both cases, the question is whether the pendulum of government policy has swung too far in the other direction? And whether the very necessary and visible hand too needs to recognise the cyclical role it has to play to ensure that this approach does not become permanent.

Some industries cannot work without government intervention, where public sector products such as Medicare or CPI linked Age Pensions couldn't be offered by the private sector or where private sector products such as private healthcare or group insurance wouldn't cover unhealthy consumers without some form of mandating or community rating of risk. But a well-functioning private sector always needs balance, where regardless of the new policies in play, competition needs to be encouraged at all costs as this underpins the market for financial services to consumers.

This paper explores the situation we find ourselves in today with regard to supply and demand and the now more visible, and likely more reluctant, hand of government. And puts forward one macro idea about how government can ensure we balance the conflict between stability and competition.

THE 30 SECOND STORY

This story is about competition and balance.

There is an oligopoly in Australia, as the insurance and superannuation industry has consolidated. Government, via the regulators, are playing an increasing and potentially reluctant role in driving this outcome, having moved far away from trusting these industries to self-correct. In itself, this is the least bad option available but the pendulum may now be shifting too far to one side and will have unintended consequences, particularly as there is a cost imposed on consumers where supply and competition is reduced.

This paper calls for an annual report for government that measures the levels of competition in these two industries, as a way to transparently reflect how the objectives of prudential stability and competition are being balanced in practice.

Why were they dancing?

One starting point is to try understand why all these people carried on dancing, writing loss making business for so long when all the warnings signs were obvious? In the life insurance space in particular, was it the fear of financial advisors not forgiving the first mover or was it an agency problem whereby the people who depended on their jobs were conflicted in taking difficult actions to close down entire product lines? Was it the flawed logic that it was better to write even loss-making business to ensure some contribution towards expenses? Or maybe, and most disturbing, was it the idea that because of the reviewable nature of these products, if you got the pricing wrong you could also correct (and recoup) later at the next repricing opportunity?

How do reviewable premiums work in life insurance?

The policyholder buys coverage under a long term contract (e.g. 20 years) but the premium rates are only guaranteed for a short period of time within that contract (e.g. 2-3 years). At the end of the rate guarantee period, the insurer can theoretically increase premiums at will. The unique challenge under life insurance, in contrast to say car or household insurance, is that some policyholder's health deteriorates and so the unhealthier members of the risk pool are unable to move to another provider if those rates increase.

Looking to economic theory for some explanation, it may have been driven by the very nature of competition and independence whereby each organisation was thinking about what the other organisation would do.

To give a simplified example, consider two organisations faced with the following choices in respect of a loss-making product:

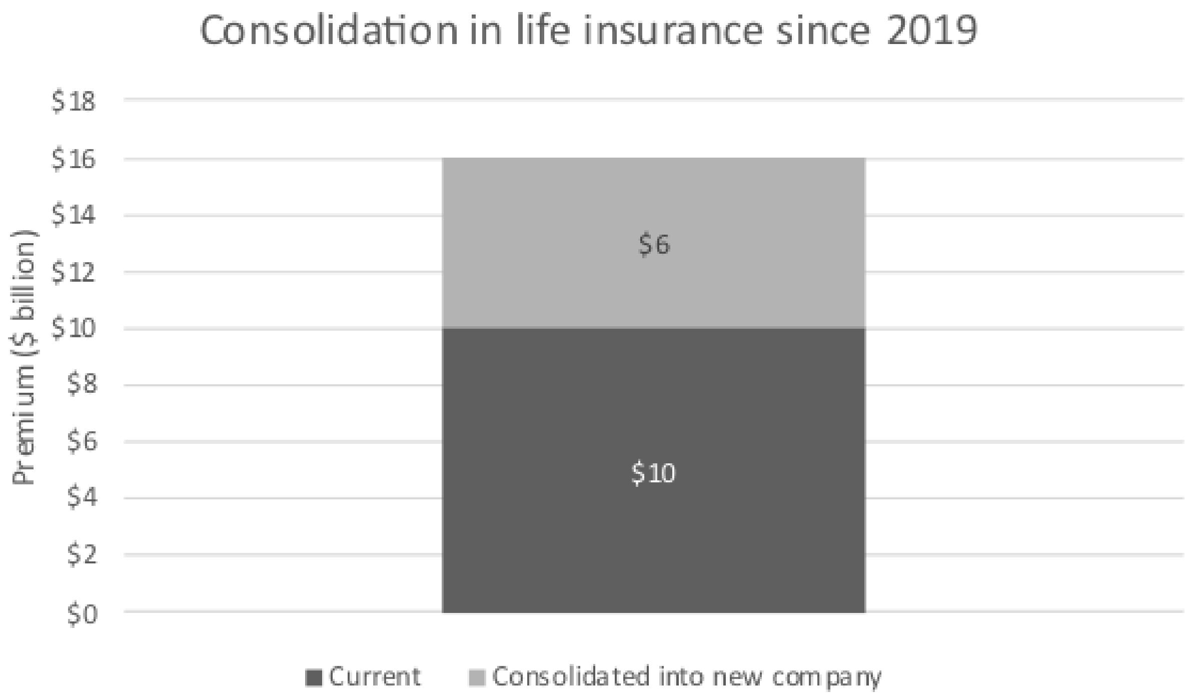
- If they both took action and repriced the loss-making product, they would both stand to increase their profits by $5m;
- If one took action and the other didn't, the one who did nothing would end up stealing the other's customers (gaining market share and ability to reprice) giving the former $10m and the latter $0; and
- If both didn't take action, both would carry on losing $5m each on those products.

The rational choice is to both take action and make $5m each but the problem is that this action can't happen simultaneously. Since each have to make this decision independently to avoid collusion, they need to constantly weigh up what the other party will do. And this is where temptation and irrationality (sometimes Fear Of Missing Out) creep in, despite the result potentially being a worse market outcome. This gets magnified in some industries such as life insurance where that organisation may believe that because they can reprice later and recoup, both taking no action is not a true picture of the final option.

This problem is a crude version of the economic puzzle called the prisoner's dilemma but it goes some way to helping explain why in the end, no-one did anything. Oddly in fact, some of the actions that were actually taken in the market, knowing the financial risks, were to introduce further first year discounts to the premium rates offered to policyholders under these loss-making products in a bid to increase volume.

The continued consolidation

In the 2019 Retender paper titled 'Where has all the competition gone?', we explored the continued wave of consolidation impacting the life insurance industry. Two years on, of the c$16bn in annual life insurance premiums in the four main product segments, close to 40% of this will have been consolidated into another entity (or closed to new business) over the last five years. And in these last five years, although distributors have entered, only one new direct life insurance license was granted and that was for a life insurer buying up a closed book of business to put it into run off.



Source: Retender estimates based on APRA Life Insurance and Claims Statistics December 2020

Similarly, the superannuation sector has undergone its own a wave of recent consolidation. Helen Rowell, deputy Chair of APRA commented in May that, "The landscape of 2013 comprised 279 APRA-regulated superannuation funds; it has since been whittled down by more than 100 to 170, and will continue to fall further as the numerous potential merger discussions currently underway take effect".

Source: APRA Deputy Chair Helen Rowell - Speech to AIST Conference of Major Superannuation Funds 19 May 2021

A rule of thumb is that an oligopoly exists when the top 5 firms account for more than 60% of total market sales. In the life insurance space, the top 5 will account for more than 85% of the market share. In group insurance as a subset, the top 3 account for more than 75%. Similarly, in the super space, the top 5 will account for a little over 40% of the market share by contributions however when you consider industry and retail funds separately, the top 5 industry funds will account for more than 60% of the market share and similarly, retail will sit at 56%.

The principle of consolidation is that it theoretically increases scale, lowers costs and creates headline growth opportunities. It weeds out the underperformers that are encumbered by structural limitations.

However, from a future competition perspective to benefit consumers, and the lens through which this paper has been considered, the long-term favourability of these outcomes is less sure. In particular, we are dancing incredibly close to a number of thresholds that in isolation might be fine but when considered in the context of their aggregate impact, suggest that we may have a new problem.

Is there a market share threshold?

In December 2009, the Australian Competition and Consumer Commission (ACCC) commenced an investigation into AMP and NAB's proposed bids for AXA.

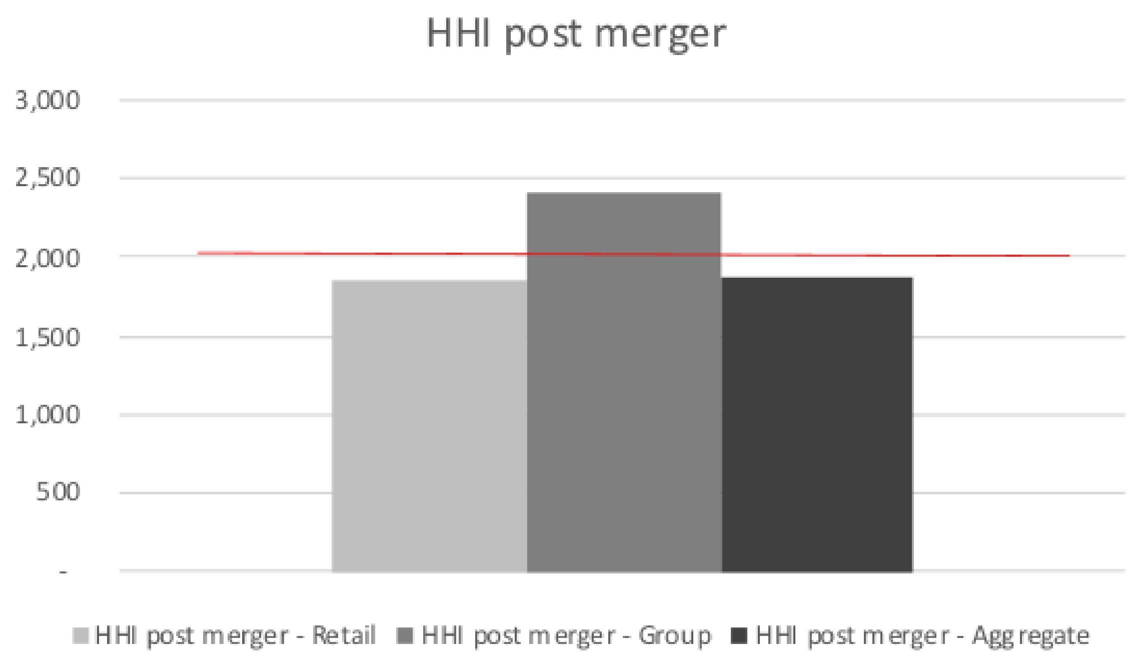
At the core of the issue was the AXA wrap platform, North, and the fact that if the transaction went ahead with NAB as the winning bidder, they would hold a significantly higher market share of funds under administration compared to its nearest competitor. The ACCC also considered that the barriers to entry for retail investment platforms were high, and AMP, who did not own their own platform, would not be able to achieve competitive scale in this space if they were not successful.

In its 41-page judgement in September 2010, the ACCC noted that in the market for the supply of retail investment platforms for investors with complex investment needs a merged NAB-AXA would hold FUM in the range of 29-37% and annual inflows in the range of 17-21% whereas a merged AMP-AXA, or AXA as a stand-alone entity, would hold FUM in the range of 7-8% and annual inflows in the range of 5-6%.

As one of their many considerations (noting this was only one factor), they utilised the Herfindahl-Hirschman Index (HHI), a commonly used screening tool to measure market concentration that results from a merger or acquisition. The HHI indicates the level of market concentration while the change in the HHI (delta) reflects the change in market concentration as a result of the merger. The ACCC is generally less likely to identify competition concerns when the post-merger HHI is less than 2000, or greater than 2000 with a delta less than 100.

The most recently announced life insurance merger (August 2021) is that of TAL Dai-ichi Life Australia ("TAL") acquiring Westpac Life Insurance Services ("Westpac") which would see TAL's aggregate market share increase to just over 30%.

At an aggregate level, the post-merger HHI is likely to be below the 2000 threshold implied by the ACCC. At a more granular group insurance level though (majority of TAL annual premiums), it exceeds the threshold but this is not due to the merger since Westpac do not have significant group business volume and the TAL market share has accumulated over time organically.



Source: Retender estimates

The reason this matters is not to call out whether the merger should or shouldn't take place (there are no other better public alternatives) but rather to ensure that consideration is being given to the dynamic of life insurance where switching life policies can be difficult (health worsening over time) and/or result in additional restrictions (new exclusions or policy conditions). The reviewable nature of Australian life insurance means that the limited practical ability to change providers can lock certain consumers into having no choice but to either accept the increases in price or reduce their cover levels to balance affordability. If consumers become captive in this way, and do not have the power to exercise choice themselves because of the nature of life insurance risk, then it is all the more important that competition is nurtured and flourishes at an institutional level to drive optimal consumer outcomes.

Size matters

In the superannuation sector, APRA has supported an industry view that only funds greater than $30bn in FUM will be able to survive. This has been driven by the idea that only large funds are 'better placed to deliver stronger investment performance and lower fees'. Adding to this steer, APRA has developed a performance-based benchmarking test as an output from the Your Future, Your Super reforms. 13 funds, representing 16% (or $56bn of FUM) of the pool that was assessed, failed this test in the inaugural August 2021 assessment and as a result were publicly named and shamed, not to mention having to now write to their members by the end of September explaining their poor performance.

At the size threshold being proposed, it's quite possible that only c12-20 funds might see a future. Further, APRA has expressed the view that small funds merging with other small funds, so called 'bus stop' mergers, are not the way forward. Witness the recent (August 2021) NGS Super and Australian Catholic Super merger being abandoned even though their combined FUM would have exceeded $23bn.

From a performance point of view, there are worrying signs that don't allow for the benefits of competition. Whilst certainly size brings scale and therefore lower fees, and despite historically being able to demonstrate that larger funds are correlated with better performance, actuarial training drums into you to consider that the past is not always a guide to the future. There is plenty of counter research that smaller funds have more flexibility and can pursue different opportunities (including different risk profiles). Smaller funds may introduce market changing innovations. But the real trend is that the performance testing will result in all funds tracking against an index, minimising the risk of underperformance (or outperformance). It might come down to one's philosophical view of the benefits of active asset management but this approach, which is being driven by the regulator rather than the private sector, is akin to driving the market towards all funds setting themselves up as index trackers.

If we only end up with 12 funds tracking an index say, we end up with a self-fulfilling outcome where there aren't alternatives to compare a different outcome in that system. Money might flow from the system, such as into self-managed superannuation vehicles, as consumers with better means deliberately seek out different risk profiles. Under this commoditised model, the competition game will shift into the other areas of the value propositions in areas such as insurance or engagement.

But of all the possible implications, there will be a shift in investment allocation away from the largest funds being able to take risks in more innovative or longer-term asset classes. It's this last potential change that could fundamentally alter the benefits of a super system that can afford to take a longer-term view in how its resources are allocated across the economy, but won't.

Champagne and tears

The wave of consolidation champagne quickly flows into the grind of integration and synergy activity. And life insurers have been here before. Ignoring the most recent acquisitions where it is too soon to tell, it's worth considering whether life insurance mergers have been successful and if not, what were some of the key lessons that might inform the current wave of merger integrations in the superannuation sector.

Insurer	Acquirer	Completion	Brand Today	Multiple of EV*
Legal and General	Colonial	1998	Closed	2.1
Prudential	Colonial	1998	Closed	
Colonial	CBA	2000	Closed	
MLC	NAB	2000	Open	
BT	Westpac	2002	Open	
ING	ANZ	2009	Closed	1.2
Aviva	NAB	2009	Closed	1.1
AXA	AMP	2010	Closed	1.2
Tower Australia	Dai-Ichi	2011	Open	1.1
Macquarie	Zurich	2016	Closed	
MLC	Nippon	2016	Open	
Onepath	Zurich	2019	Open	1.0
Suncorp (Asteron)	TAL	2019	Closed	0.7
AMP	Resolution	2020	Closed	0.82
Comminsure	AIA	2021	Closed	1.1
BT	TAL	Expected 2022	Open	0.96

Source: Estimates based on market commentary at the time and so may not reflect the true multiple

The multiples of earnings paid for some of the historic wealth management businesses in Australia, noting higher interest rates back then, ranged anywhere from 16 times up to 26 times. Typically insurers however are considered in terms of their embedded value (EV), that is, the price paid relative to the present value of their future distributable profit stream allowing for capital requirements. Legal and General back in 1998 was completed at 2.1 times EV whereas today transactions are being completed at between 0.7-1.1 times. Any comparison is simplified as interest rates have fallen over this c20 year period (increasing EV for the same cashflows) but then so too have funding costs. Regardless, there is broad market consensus that value has been eroded, significantly in some cases, in many of these entities.

Why was so much value lost? Claims experience and market dynamics certainly played a role that could not have been foreseen but were there reasons where the industry had some control? A paper titled ‘The hubris hypothesis of corporate takeovers’ by Richard Roll, although dated (1986), suggests that takeovers ‘reflect individual decisions’ and comments that the average individual bidder has only had the opportunity to make a few takeover bids in their careers. Ignoring the conflicts of interests with corporate advisors who may have done the initial transaction more frequently, it raises the question of why any single CEO (or management team) would be good at something they may only ever do a handful of times.

The Australian experience may just turn out to be a specific set of circumstances related to the success of bancassurance, and the view that banks had for their life insurance business units that accounted for sometimes as little as 5% of their overall business. Did managers rotate in and then out quickly to get back to the other 95% of the business, did they understand and have resources to constantly upgrade systems and product, was corporate knowledge retained over time on one of the most complex product lines? Was it something at a more macro level whereby the wave of demutualisation’s created a misaligned position between policyholders and shareholders who each arguably would have different objectives?

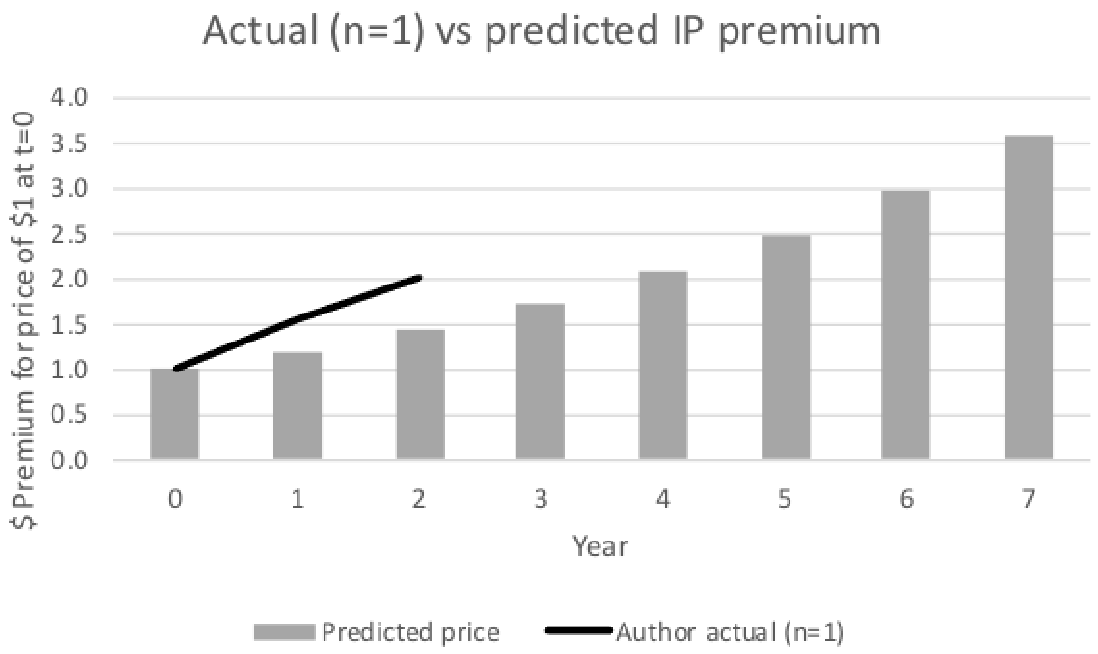
Judging by the number of remediation projects that emerged years later, and the prices paid by specialist insurers to acquire these businesses off the banks, there are certainly important lessons to be taken away for the modern acquirers of life insurance businesses. Equally, with the wave of superannuation consolidation, the integration lessons have equal bearing so that this not-for-profit industry doesn’t find itself in a similar position in 10 years-time where this time the cost of the mistakes and value erosion are borne by members and not shareholders.

N=1

1 October 2021 is the latest date for the new Individual Disability Income Insurance (IDII) product to be on market. APRA, recognising that the life insurers weren’t going to make changes to their loss-making Disability Income (DI) products, stepped in with some mandated product design proposals.

In Retender’s 2020 paper titled ‘The sustainability fallacy’, we questioned whether these changes went far enough, proposing 8 key recommendations that included quarantining of backbook’s, aligning long term remuneration, going further on the product side and being honest with policyholders about the impending prices. Similarly, recognising that this wasn’t a product problem only, the Actuaries Institute set up a Taskforce on DI. In an unprecedented exercise, working with all industry stakeholders including APRA, they published their findings (May 2021) and made 46 recommendations to try address the future DI challenges at a more macro level.

In that Retender paper, we predicted that legacy sold IP products might see price increases of 20% p.a. for the next 7 years. Following this prediction, this author's IP premiums have increased by 56% in the first year and another 30% in the second. We will continue to monitor this actuarially credible sample of one over time.



Source: Retender author and Sustainability Fallacy paper 2020

One should also consider that within this construct, advisor commissions theoretically go up by the same amount as these are tied to the premiums paid by the consumer. So are financial advisors, already struggling in a consolidating industry too, potentially misaligned? In practice, many consumers in this position will look to reduce their cover to balance affordability so potentially a significant amount of work gets done by the advisors, dealing with irate customers, to only end up in a similar net revenue position.

Life Practice Guide (LPG) 260 titled 'Conflicts of interest under Section 48' references the Life Insurance Act (1995) and particularly considers Section 48 which 'imposes a duty on directors of a life company to give priority to the interests of policy owners referable to a statutory fund of that life company where those interests conflict with the interests of shareholders. This duty is in addition to the general duties of directors under the Corporations Act 2001 (the Corporations Act) and is significantly more stringent.'

One question to consider is how this check and balance built into the system, whereby policyholders come first, is playing out in practice. As one example, how might it be viewed if insurers increase reviewable level premium policies written historically (e.g. 10 years ago) to just below the level premium price that could be achieved today for that consumer who is now 10 years older. Would this be resetting the incorrect price to the true price or could it be viewed that the insurer took a risk and made a loss but despite this, can now charge the maximum possible because the consumer has nowhere else to go?

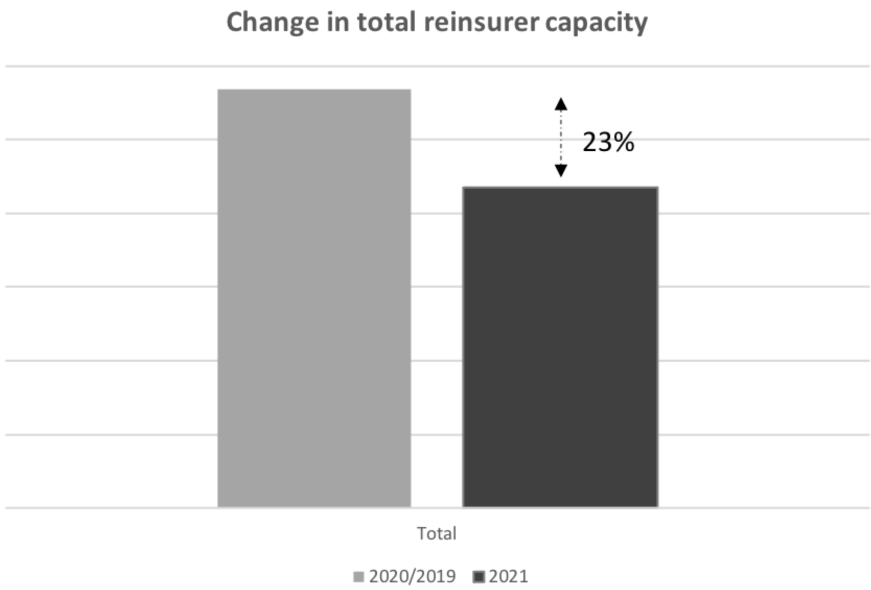
The other dynamic to consider was whether all the continued engagement with industry on DI products from 2019, effectively a lifeline to save them from spiralling losses they couldn't save themselves from, only served to make the problem worse? That is, instead of the industry taking difficult action back then, we may now have three more years of business that will have to be dealt with down the line. In scope through all these reviews has also been the focus on solving the problem for new business which didn't solve the real challenge which was one of how to deal with these legacy books.

Since APRA's original proposal to the industry, one of the key changes relating to limiting the policy terms to 5-years only, a backdoor solution to the legislation constraints, has already been deferred (to October 2022) and still needs a lot more work to be viable. The continual response to why legislation isn't changing typically comes back to the 'too difficult bucket' and as a result we've ended up with a number of workarounds (the 5-year term, other product tweaks, additional capital in a low funding environment etc) that may do very little to protect consumers from the spiral risk of deteriorating insurance pools.

Timing is everything

Consistent with the cycle of profits and losses, reinsurers, with no consumer brand to manage, tend to dip in and out of markets to provide capacity.

Retender runs an annual survey of reinsurance capacity which has coverage of more than 65% of the insurance and reinsurance market along with more than 50% of the superannuation market. Our 2021 survey results certainly continued to show significant appetite from reinsurers for 'the right opportunity' and continued the preferences shown for group insurance over advised insurance. However, it also showed a shift in this capacity over the last 3 years. In particular, the 2021 capacity, adjusted for the most recent few months activity and following only the same cohort who have contributed to each year of the survey, shows that there has been a significant drop in the aggregate reinsurer capacity from 2019/2020 to 2021. The biggest component of this comes from advised insurance and is driven by recent losses.



Source: Retender 2021 capacity survey

At the same time, APRA is pushing forward with its changes to one of the standards (LPS117) related to counterparty exposures which, amongst other outcomes, continues to limit the availability of offshore reinsurance capacity. This review was announced in December 2017 and commenced in H2 2018 and included was the reference that 'Until the outcomes of the review of LPS 117 are clearly known, APRA is not inclined to grant any further 'discretionary' approvals to allow entities to mitigate exposures to non-registered reinsurers for the purpose of …'. The final version is imminent but offshore reinsurers will tell you how difficult it is to write business in Australia. Certainly, you won't find local reinsurers knocking down the doors to government asking for this to be made easier for their offshore competitors nor enough offshore reinsurers contributing to the consultation papers given their capital can just as easily be deployed elsewhere globally where it is easier to write business. In the end, consumers lose out where capacity is lowered and the concern is that barriers in this space are preventing the replacement of capacity by other providers exactly at the time it is needed.

Hot potato

If the financial advisors and private sector organisations find themselves conflicted, that is, the self-correcting market cannot be relied on, there may be only two government options.

Ideally owning the challenge is APRA but there is a conflict between prudential stability and competition. Its purpose statement is to 'balance the objectives of financial safety and efficiency, competition, contestability and competitive neutrality and, in balancing these objectives, is to promote financial system stability in Australia.' Competition is secondary to prudential stability, not the other way around. So, APRA do not own the government role for ensuring competition.

The ACCC is the other body but whose involvement in this particular space appears to be primarily related to sizeable merger assessments rather than through ongoing engagement with industry. Their role states that 'We focus on taking action that most promotes the proper functioning of Australian markets, protects competition, improves consumer welfare and stops conduct that is anti-competitive or harmful to consumers.' Here, prudential stability is ignored which would potentially pendulum the problem too far away from balance.

We explore below a simple proposal to take a first step towards a better outcome for consumers.

So what?

In his book, ‘How Markets Fail?’, John Cassidy brilliantly articulates the difference between utopian and reality economics. And the reality economics for the life insurance and superannuation industry is that government cannot rely on an invisible hand. If anything, the author believes that APRA in particular can be commended for steering these industries through such a difficult period, playing the hand that it has been dealt.

In fairness, the insurer losses were actually a consumer benefit as they (consumers) were getting the benefit of the industry not charging rationally for the actual claims that eventually emerged. However the question we are asking is whether the pendulum has swung too far the other way now in response? Government must balance its objectives and just like market cycles that need to be brought into equilibrium, we should be recognising that this same logic applies to the competition cycle.

The other long-term dynamic to consider here is that if government goes further than its mandate to effectively strengthen and protect a handful of large entities, eventually it becomes locked into this protection. These entities become too big to fail and at a point, particularly for some of these entities that need radical reform, prudential stability trumps any form of better consumer outcome.

And here we come to a proposed way forward, which is based on transparency and the adage that ‘what gets measured, gets done’. The Productivity Commission assesses competition on an ad-hoc basis - two reports were issued in 2018, the first assessing competition in the Australian Financial System (but life insurance and superannuation were out of scope) and the second considered specifically Superannuation (which excluded retail insurance). Both reports were based on pre 2018 information which has become dated. To maintain relevance and real-time assessment, Retender propose that government request an annual report, ideally from APRA, that sets out how competition is being considered in these industries on an annual basis.

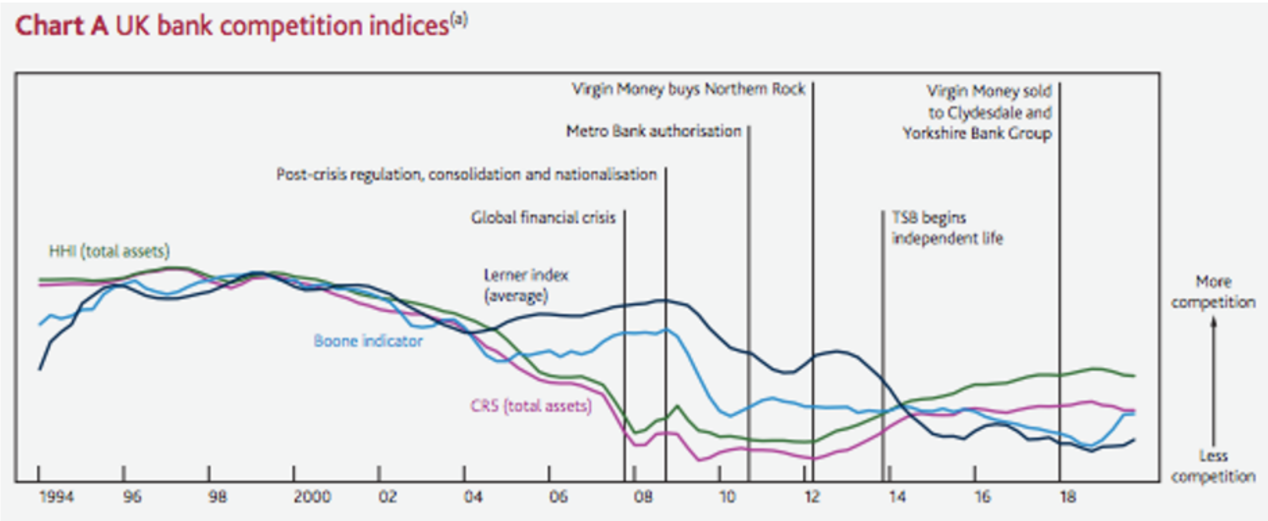
There is some precedent for this approach. In the UK, the Prudential Regulation Authority (PRA) is required to provide an annual report, at the request of government, that sets out how they are delivering against a secondary objective which came into force on 1 March 2014:

‘When discharging its general functions in a way that advances its objectives, the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities’.

Their report measures a number of areas, including what research is being done on competition or how many banks and insurers are authorised each year. They refer to the setting up of a New Insurer Start Up unit (NISU) in 2018 which may give some ideas for a dedicated government unit tasked with ensuring the barriers to entry are minimised. One reference in the report in particular stands out where they comment that ‘Regulatory thresholds ensure that the regulation of different-sized firms is commensurate to the risks that they pose to the financial system, and are therefore sensible from a risk as well as a competition perspective’.

This thinking is critical to ensuring that innovation can take place, where a one size fits all approach which can only be implemented for the scale players isn't allowed to become standard.

Their report also measures a number of competition indices for banks and how these track over time. Not all of these would be relevant for life insurers and superannuation (many of these indices rely on knowing the difference between the price charged and marginal cost, easy in banking but not so in life or super) but the principle is the key.



Source: RPRA Annual Report 2019-2020, Annual Competition Report — June 2020

Given that the regulator is privy to the true nature of price competition and margins, adjusted indices can be created that reflect the industry aggregate position each year and create a transparent lead indicator of competition thresholds. A government body, a visible hand, is the only party that can monitor and report on these indicators transparently and effectively.

The risk must exist, and be material, that any party using its market power or relying on consumers having little choice, can lose their customers. The report should articulate how this risk evolves over time and where organisations exceed their mandate, additional capital requirements should be the form of action rather than government trying to juggle two competing objectives. As a minor consideration, the government 'hand' should also be considering its role in the wave of consolidation. If the industry consolidates, so too should government oversight. It is a variable and needs to adjust itself to manage risk, not aim to remove it. We suspect that government does not want to be playing its current role in any case, so the motivations between industry and government here are aligned.

Increased capital requirements, repricing power, lower reinsurance capacity, more regulation, less competition – all of these mean higher cost for consumers. In the current environment where member retirement erosion, cost and affordability are critical performance indicators, what is the point of all this industry change if we aren't focused on these latter measures as primary outcomes? An annual report for government will take that first step to transparently reflect how the objectives of prudential stability and competition are being balanced in practice to seek the best outcomes for consumers.

Thank you for reading. We'd welcome any views or thoughts to help support and further the industry debate. If you would like to discuss, please get in touch.

Other papers by **retender**

The sustainability fallacy
Where has all the competition gone?
The cost of consumer expectations
Debugging life insurance (on request only)
Unintended consequences
The future of life insurance (Actuaries Institute Dialogue paper)