**Private Motor Insurance Market Investigation**

**Response to Annotated Issues Statement and Working Papers**

**Royal & Sun Alliance Insurance Plc**

**Chapters**



**Annexes**

## A. Executive Summary

A.1 Royal & Sun Alliance Insurance Plc ("RSA") welcomes the Competition Commission's ("CC") work on the private motor insurance ("PMI") market investigation to date and we look forward to working with the CC in the next phase of the investigation with a view to developing lasting and comprehensive market solutions in consultation with both the Financial Conduct Authority ("FCA") and consumers.

A.2 The main body of this paper will address the CC's Annotated Issues Statement ("AIS") and RSA's response to it (with the main focus being on the CC's Theory of Harm 1 ("TOH1")). We also comment here on certain points made by the CC in its associated Working Papers. Where we have more detailed comments on particular issues arising, these are addressed in the relevant Annexes to this paper.

*Annotated Issues Statement*

A.3 RSA broadly supports the AIS. We agree with the CC's continued focus on TOH1 and the issues surrounding credit hire and credit repair and we consider these are the key issues for the PMI market and ultimately for consumers.

A.4 With regard to the CC's other theories of harm, we would urge the CC to continue to liaise closely with the FCA on the market study and thematic reviews it is conducting (including those relating to add-ons) in order to avoid duplication and inconsistent outcomes.

A.5 Our view remains that the key focus of the CC must ultimately be to ensure a long-term solution aimed at removing the inefficiencies (and hence cost) inherent in the existing system to ensure that customers can benefit from the highly competitive UK PMI market through even lower premiums and greater certainty. An outcome which ensures a level playing field for insurers, brokers and other PMI service providers, protects the fundamental legal rights of consumers, retains and strengthens efficiency incentives and ultimately removes cost from the system should be the ultimate goal of the market investigation.

*Theory of Harm 1*

A.6 RSA broadly agrees with the CC that the lack of control on costs identified in TOH1 results in potential for harm to consumers and we believe that features of TOH1 may give rise to an 'adverse effect on competition' ("AEC"). While we consider that the scope for consumer harm is greatest (by a factor of four or more) in the provision of temporary replacement vehicles ("TRVs"), we recognise that similar issues apply in respect of repairs and total loss.

A.7 We welcome the CC's recognition that, as a result of established common law, under the prevailing legal framework a "mark-up" can be generated as between the actual and reasonable costs funded by at-fault ("AF") insurers on not-at-fault ("NAF") claims (termed 'overcosting' by the CC), and its recognition that referral fees are a symptom and not the cause of those mark-ups. As set out in Confidential Annex 2[1], RSA's evidence on the magnitude of mark-ups on NAF TRV and repair claims broadly matches the CC's findings. Furthermore, RSA agrees that the CC's next task is to analyse the economic and competitive impact of the mark-ups it has identified.

A.8 In doing so, RSA urges the CC to consider the economic flows among insurers and third parties arising from the separation of cost liability and cost control. As explained in Annex

[1] See Confidential Annex 2, RBB Economics Paper, '*Quantification of "overcosting" of TRV and repair services*'.

1[2], the mechanism for consumer harm under TOH1 is a subtle one. Where the mark-up on NAF claims is ultimately retained by insurers it will ultimately feed back into the underwriting result and ensure that premiums remain highly competitive. Mark-ups retained by insurers cannot be assumed to lead to higher PMI premiums or to consumer detriment.

A.9 In contrast, whilst the prevailing legal framework allows for non-insurers to be involved in NAF claims and hence to capture the available mark-up, this may result in upward pressure on PMI premiums via "leakage", ultimately to the cost of consumers. Using evidence from the CC's market investigation, RSA estimates that this leakage amounts to between £105 million and £190 million per annum across the PMI industry.

A.10 Within this estimate, around 80-90% of the potential leakage is found to result from the use of credit hire. This confirms that the potential for consumer harm under TOH1 is significantly greater in respect of TRVs, and that therefore the CC should focus its attention on addressing the issues in respect of TRVs within its continued overall focus on TOH1.

A.11 As is explained below[3] and in the economic paper at Annex 1, alongside leakage, the CC's key economic consideration should be on *incentivising efficient operation*. It is essential (whether looking at TRVs or repairs) that insurers remain incentivised to operate as efficiently as possible – indeed, any crude attempt to mandate subrogation at cost would have a chilling effect on such incentives, with the likely result that total repair bills would *increase*. RSA discusses in Annex 1 the beneficial impact of the legally permitted mark-ups on efficiency incentives, and the potential adverse consequences for consumers of removing those mark-ups (i.e. the potential for consumer detriment arising from subrogation at cost)[4]. In particular, we demonstrate that subrogation at cost benefits inefficient insurers at the expense of efficient insurers and thereby, all else equal, creates a powerful incentive to operate inefficiently.

A.12 In summary, RSA would emphasise that the CC should not lose sight of the fact that any 'overcosting' on NAF claims arises out of the prevailing legal framework which permits insurers to recover reasonable costs and to retain any mark-up from actual costs incurred. Further, this mark-up has no net impact on PMI premiums, absent the intervention of non-insurers, because any benefit retained from the mark-up where the insurer is NAF offsets any additional costs where the insurer is AF. In addition, the system actually incentivises insurers to pursue cost efficiencies and to reward safer drivers with lower premiums than riskier drivers.

A.13 Conversely, a simple ban on referral fees which extends to credit hire/repair and/or an enforced subrogation at cost model may actually *increase* PMI costs and premiums by removing the incentive to pursue cost efficiencies and would result in an effective subsidy of the least efficient insurers by the most efficient, ultimately resulting in consumer detriment.

*Other Theories of Harm*

A.14 RSA continues to believe that the area with the greatest potential for harm (and hence the area where the CC should now focus its attention) is covered by the issues raised in TOH1. As regards the other Theories of Harm identified in the AIS, we believe that none of these gives rise to an AEC. In particular:

(i) RSA welcomes and agrees with the CC's recognition that there is no evidence of any underprovision in services or quality of insurer-managed repairs;

[2] See Annex 1, RBB Economics Paper, '*PMI market investigation: economic analysis of mark-ups on subrogated NAF claims*'.
[3] See section B below.
[4] *Ibid.*

(ii) RSA welcomes the CC's recognition of the established legal principles that underpin entitlement to a TRV, including the requirement to assess need and (in respect of credit hire in particular) the need to consider whether the customer is impecunious. We do not consider that there are any issues with regard to underprovision of TRVs in respect of captured NAF claims and we look forward to commenting further on the CC's analysis after it has completed its review of call records;

(iii) RSA does not agree with the CC's characterisation of Northern Ireland as 'highly concentrated' and consider that, with at least 17 PMI providers active in a small market, and considerable additional cross-border competition (and potential competition) from providers based in the Republic of Ireland, Great Britain, Gibraltar and any other relevant off-shore jurisdictions, there remains considerable choice for Northern Irish consumers;

(iv) RSA urges the CC to liaise closely with the FCA in respect of any further consideration of issues in respect of add-ons, especially in light of the FCA's ongoing market study and related thematic reviews;

(v) RSA welcomes and agrees with the CC's conclusion that there are no obstacles to switching and indeed that rates of switching are very high relative to comparable products. This reflects our own experience that the UK PMI market is highly competitive. To the extent that there is any consumer confusion in relation to No Claims Bonus ("NCB") and NCB protection, we consider the FCA best placed to deal with this issue;

(vi) RSA broadly agrees with the CC's conclusions in respect of PCWs, who have clearly delivered positive change to the PMI market by increasing choice and transparency and ultimately lowering prices for PMI consumers. We consider that most-favoured nation ("MFN") clauses can be a useful way in which consumers can compare premiums and PMI policies with confidence, but that there is greater cause for concern in respect of market-wide MFNs. We are, however, concerned that the impact of MFNs in general will be: (i) to keep insurers' web-based prices artificially high; and (ii) to stifle innovation aimed at reducing PMI premiums. We look forward to commenting further once the results of the CC's assessment of potential efficiency gains arising from MFNs is available; and

(vii) RSA broadly welcomes the CC's dismissal of concerns under TOH5 in respect of vertical relationships. In particular, we agree that consumer harm is unlikely to arise directly from non-exclusive paint supply contracts and strongly believe that any residual concerns regarding possible indirect harm to consumers are best addressed under TOH1.

*Outcomes*

A.15 RSA would like to see the following outcomes arising from the market investigation to the ultimate benefit of consumers:

(i) Protection of the NAF customer's right to full rectification;

(ii) Maintenance and enhancement of the customer experience, including the speed of claim, and reduction in the scope for disputes;

(iii) Closer alignment of the incentives of the party controlling costs (i.e. the procurer of services) with the party ultimately responsible for paying for those services (i.e. the AF insurer); and

(iv) A reduction in overall costs, whilst protecting and strengthening incentives on insurers to operate as efficiently as possible, to ensure that savings can be passed through to consumers in the form of lower premiums.

*Conclusion*

A.16 RSA broadly supports the AIS and agrees with the CC's continued focus on TOH1 as this is the only area identified which RSA considers may give rise to an AEC.

A.17 The issues are undoubtedly complex and the CC must continue to be wary of the unintended consequences that could result from any 'quick-fix' attempts to alter the prevailing legal framework (such as a simple ban on referral fees and/or a mandatory subrogation at cost model. Indeed, such changes would not only have a negative and potentially restrictive effect on innovation, but would also risk removing any incentive on insurers to pursue cost efficiencies and could ultimately lead to higher PMI premiums.

A.18 Given that the potential for 'leakage' and hence greatest risk of net increased costs arise in respect of the provision of TRVs, RSA considers that the CC should focus its attention on addressing these issues in order to deliver the greatest potential benefit to consumers.

## B. Theory of Harm 1: Separation of cost liability and cost control (moral hazard[5])

B.1 Under TOH1, the CC considers whether the separation of cost liability and cost control could give rise to consumer harm in respect of the delivery of TRVs, provision of post-accident repair services and in respect of vehicle write-offs. Issues in respect of each of these three activities represent a manifestation of the more general issues in the PMI market arising where NAF claims costs are recovered from AF insurers, where the AF insurers have limited or no control over those costs.

B.2 In Working Papers 2 and 3, the CC considers whether the separation of cost liability and cost control has resulted in 'overcosting' in the delivery of TRV and repair services. The CC itself is careful to be clear that 'overcosting' is not used pejoratively and that there may be legitimate reasons for any difference in costs highlighted. The current legal framework permits insurers to retain the mark-up between actual costs and reasonable costs[6]. RSA agrees and considers that overcosting will not necessarily lead to detrimental outcomes from an economic perspective, provided that the available mark-up is captured and retained by insurers. For this reason, we urge the CC to consider the economic flows among insurers and third parties arising out of the separation of cost liability and cost control identified in TOH1 and to consider the impact of these flows on overall costs. In particular, we consider that control of NAF claims by insurers will not only lead to lower premiums, but will also drive efficiency and a better service for customers.

B.3 Throughout the OFT market study and in our substantive submissions to the CC to date[7], RSA has consistently shown that mark-ups on TRV and repair services provided by insurers represent not only a marginal cost for AF insurers, but also an off-setting positive effect (i.e. a marginal benefit) for NAF insurers. Absent non-insurer intervention, these two effects can be expected to effectively offset each other such that there is no overall increase in the aggregate level of industry costs. Further, insurers will be incentivised to operate as efficiently as possible to maximise the mark-up they retain where they are NAF because any additional benefit derived from this increased efficiency will ultimately flow back to consumers in the form of downwards pressure on premiums.

B.4 These points are addressed in Annex 1[8], which demonstrates:

(i) The mark-up permitted by the prevailing legal framework, in isolation, does not increase PMI premiums in aggregate, because any negative effect (i.e. increases in marginal claims costs where the insurer is AF) is likely to be offset by a counter-balancing positive effect (i.e. a cost benefit where the insurer is NAF and has captured the claim) that *lowers* marginal cost. See further section 2 of Annex 1;

(ii) The mark-up identified at (i) above also incentivises NAF insurers to pursue cost efficiencies. Specifically, the more efficient the NAF insurer can be in controlling and managing the claim (i.e. in procuring repairs and TRVs at the lowest cost), the greater the mark-up that will be available for that NAF insurer as a proportion of the

[5] We do not consider the CC's use of the terminology 'moral hazard' to be appropriate in this context. Moral hazard would usually refer to a case where someone takes on more risk knowing they are insured (i.e. the protection of being insured makes them act in a riskier way). The issue here is that the law allows a mark-up to be made and so whoever controls the claim will rationally seek to make (and retain) that mark-up.

[6] The law clearly permits the party dealing with the NAF claim to retain a mark-up between actual and reasonable costs, provided the overall cost is reasonable, as the CC recognises in its Working Paper 2, 'Theory of harm 1: Overcosting and overprovision of repairs', paragraph 33. This mark-up exists across the industry and was most recently confirmed in *Coles v Hetherton*, [2012] EWHC 1599 (Comm).

[7] See, for example, section 6 of RSA's Overview Submission to the OFT (February 2012) and paragraph 1.10 *et seq.* to RSA's Response to the CC's Statement of Issues (January 2013).

[8] See Annex 1, RBB Economics Paper, '*PMI market investigation: economic analysis of mark-ups on subrogated NAF claims*'.

amount funded by the AF insurer. In turn, this leads to a lower cost for the funding AF insurer, lower overall industry costs and therefore ultimately lower premiums. See further section 3 of Annex 1; and

(iii) This balance between marginal costs and marginal benefits deriving from the mark-up identified at (i) above is upset where non-insurers intervene in the claims process and therefore capture (and retain) some of this mark-up. This intervention places a net upward pressure on PMI premiums. In other words, where the mark-up is retained by insurers, the highly competitive nature of PMI in the UK will necessitate insurers ultimately feeding such mark-up through to lower premiums whereas, in direct contrast, where non-insurers control NAF claims and retain the mark-up, any such mark-up will 'leak' from the industry and not be passed on in the form of lower premiums. The extent of this 'leakage' will depend both upon the proportion of claims that non-insurers are able to capture and the value of the reasonable cost mark-up[9]. However, using evidence from the CC's market investigation we estimate that this leakage amounts to between £105 million and £190 million per annum across the PMI industry. See further section 4 of Annex 1.

B.5 In other words, the potential harm to consumers (and ultimately any potential AEC) arises not from the overcosting itself, but from the 'leakage' of the available margin to non-insurers. This 'leakage' represents margin that is lost to the industry as it is not available to insurers and hence cannot be passed through to customers in the form of lower premiums.

B.6 Furthermore, as is also clear from Annex 1, the prevailing legal framework gives rise to a distributional effect in favour of safer drivers – in other words there are incentives on insurers to price PMI such that high risk drivers will face higher premiums than lower-risk drivers[10].

B.7 In addition, and as explained at section 5 of Annex 1[11], the existence of this mark-up also incentivises insurers to drive cost efficiencies because the level of efficiency in the rectification of NAF claims feeds through to PMI premium pricing via its impact in the marginal cost of underwriting. A subrogation at cost model would be expected to result in less pressure to pursue efficiencies in NAF rectification services, and therefore higher costs for those services.

B.8 Consequently, by incentivising NAF claims controllers to pursue efficiencies in NAF claims rectification, the prevailing legal framework leads to lower industry costs, and therefore lower PMI premiums, than would be the case under a subrogation at cost model.

B.9 It has been suggested that the various methods by which insurers have sought to retain the mark-up between actual and reasonable costs of repair have led to a significant overall increase in repair costs, which would be further exacerbated should all insurers adopt similar models; the implication being that insurers should be prevented from benefiting from any legally permitted mark-up on NAF claims (i.e. a mandatory subrogation at cost regime). However, given the efficiency incentives identified above (and at Annex 1[12]), such a

[9] See further Annex 1, RBB Economics Paper, '*PMI market investigation: economic analysis of mark-ups on subrogated NAF claims*', section 4. For a contrasting example of a CHC working together with an insurer to come up with a solution that allows the provision of TRVs to NAF customers at lower cost, we would point the CC to the 'Subscriber Model' that Enterprise Rent-A-Car ("ERAC") has with RSA. For further details on the ERAC Subscriber Model, please see Annex 1.1 of RSA's Response to the CC's Initial Questions for Insurers and CC Working Paper 3, 'Theory of harm 1: Overcosting and overprovision of TRVs', paragraph 41.
[10] See Annex 1, RBB Economics Paper, '*PMI market investigation: economic analysis of mark-ups on subrogated NAF claims*', section 2.2.
[11] See Annex 1, RBB Economics Paper, '*PMI market investigation: economic analysis of mark-ups on subrogated NAF claims*', section 5.
[12] *Ibid.*

suggestion could be expected to harm dynamic incentives, and to lead to inefficiency, higher costs and ultimately higher PMI prices.

*TRVs*

B.10 In the AIS and the relevant Working Paper[13], the CC identified that the cost of credit hire was around twice that of equivalent direct hire rates and that the average hire duration was also longer (by about 3.7 days) for credit hire than direct hire. The value of this difference was estimated to be around £600 per hire. RSA broadly agrees with these conclusions, as explained in Confidential Annex 2[14].

B.11 Consequently, given that the increased costs are around three times those seen in respect of repairs or total loss[15], the potential for consumer harm is significantly greater in respect of TRVs. In addition, as explained in Confidential Annex 2, the CC's findings may suggest that around half of the mark-up on TRVs does not translate into revenues for insurers and therefore 'leaks' from the insurance industry[16].

B.12 Given that the CC has identified both a greater potential overcosting in the provision of TRVs and a far greater degree of 'leakage' both in absolute terms and as a proportion of the available mark-up, it follows that there is the greatest potential for consumer harm arising out of the issues identified in TOH1 in respect of TRVs.

B.13 Accordingly, the CC's key economic consideration should be on *incentivising efficient operation* in relation to TRVs, in particular by addressing the overcosting and leakage identified in respect of credit hire services to NAF claimants[17].

*Repairs*

B.14 RSA agrees with the CC that AF insurers' lack of control over the cost of repairs leads to increased repair costs. We also broadly agree with the magnitude of average mark-ups contained in the AIS (i.e. an average of £200 more for insurer-managed repairs and up to £400 for credit repair[18]).

B.15 Mark-ups are, however, only one of several contributory factors to overall repair costs. When assessing repair costs it is important that the CC also considers the absolute costs involved and not just mark-ups that are paid on individual cost elements. Consider the position of two insurers undertaking identical repairs. Insurer A operates a highly efficient repair network with an average cost of £1,300 and an average mark-up of £200 (i.e. an average cost per repair subrogated to AF insurers of £1,500). Insurer B applies no mark-up to its cost of repairs, subrogating at cost. However, if Insurer B's repair operations are less efficient than Insurer A such that the average cost of repair is £1,500, this will result in the same ultimate cost to the AF insurer (with the additional disadvantage that technical efficiency has been harmed).

---

13 CC Working Paper 3, 'Theory of harm 1: Overcosting and overprovision of TRVs'.

14 See Confidential Annex 2, RBB Economics Paper, '*Quantification of "overcosting" of TRV and repair services*', section 3. Indeed, RSA data also indicate that the overcosting of credit hire services settled outside the GTA could potentially be significantly greater than the overcosting of credit hire services settled within the GTA framework.

15 Repairs and total loss are discussed later in section B.

16 See Confidential Annex 2, RBB Economics Paper, '*Quantification of "overcosting" of TRV and repair services*', section 3.

17 The extent of this overcosting is quantified in Confidential Annex 2, RBB Economics Paper, '*Quantification of "overcosting" of TRV and repair services*', section 3.

18 See Confidential Annex 2, *ibid*, section 4. As this Annex demonstrates, evidence from RSA's business appears to be consistent with the CC's assessment that the scale of overcosting on repair services is substantially greater for repairs managed by CMCs rather than by NAF insurers. Further, the CC's own results suggest that the referral of repairs to CMCs may lead to substantial 'leakage' of repair cost margins from the insurance system.

B.16 In other words, the CC should not lose sight of the following two points:

(i) Insurers with lower (or indeed no) mark-ups will not necessarily have the lowest total repair costs (and indeed RSA's own experience suggests that total repair costs subrogated to it are often among the highest from those insurers who claim not to apply any mark-ups); and

(ii) Any attempt to mandate subrogation at cost is likely to reduce incentives on insurers to operate efficient repair and claims networks and may therefore have the unintended consequence of actually *increasing* PMI costs and hence ultimately premiums.

B.17 RSA notes that whilst the CC has not yet considered the effects on competition of the mark-ups identified, the CC intends to consider this further[19]. As for TRVs, this is a critical part of the analysis of overcosting of repair services. Indeed, it is essential that the CC understand the economic flows and the impact of these on insurer costs and revenues overall.

B.18 In addition, RSA agrees with the CC's overall conclusion that consumer harm is unlikely to arise directly as a result of non-exclusive contracts with paint manufacturers and RSA strongly believes that any residual concerns the CC may have regarding possible indirect harm to consumers from paint supply contracts are best addressed under TOH1. RSA discusses paint supply contracts further below.

*Total Loss*

B.19 The issues that arise out of any overcosting in respect of total loss claims are in essence the same as those identified for TRVs and repairs above. Insurers seek to retain any mark-up arising from the difference between agreed and actual final salvage values mainly through the receipt of referral fees and commission payments[20] (which the CC found to indicate overcosting in the region of £200 per NAF written off vehicle). Crucially, however, the mark-up is not a factor of the underlying legal framework – rather, it arises by the controller of the NAF claim setting low salvage values, resulting in a mark-up opportunity for salvage companies.

B.20 RSA agrees with the CC's conclusions that claimants are not directly affected, given that the salvage amount has no impact on the final settlement received by the claimant (calculated by the car's pre-accident value according to third party independent sources).

B.21 Ultimately, to the extent that the issues identified give rise to increased overall claims costs (for example as a result of the transfer in value from the AF insurer to the NAF claims controller and as a result of greater 'leakage' to non-insurer participants), RSA considers that these should be addressed as part of the overall assessment of increased claims costs discussed above.

B.22 In addition, RSA notes that the CC has identified that NAF own insurer write-offs are 15% (or around £300) more expensive than captured NAF write-offs[21], this being despite the fact that 8 out of the 10 largest insurers said that they did not differentiate between how they handle AF, NAF and captured write-offs[22]. We agree with the explanation for this provided in the Working Paper that captured NAF write-off payments are typically lower in value

[19] AIS, paragraph 90.
[20] RSA does not receive referral fees or commission payments in relation to vehicle write-offs.
[21] CC Working Paper 6, 'Theories of harm 1 and 2: Vehicle write-offs', paragraph 30.
[22] RSA does not differentiate between fault type when handling vehicle write-offs.

because a claimant is more likely to deal with a third party insurer when the claim involves a less valuable car[23].

*Conclusion on TOH1*

B.23 RSA agrees with the CC that AF insurers' lack of control over the costs of claims leads to increased costs overall within the industry. In particular, RSA agrees that the evidence adduced from the CC's statistical analysis of claim costs[24] demonstrates that a lack of control over TRV costs (and, to a lesser extent, repair costs) can give rise to overcosting.

B.24 Of the individual elements of the cost of claims, RSA also agrees with the CC that the overprovision of TRVs results in the greatest additional mark-up (around two to three times that identified for repair or total loss).

B.25 It is essential that the CC now seeks to understand better the impact that the mark-ups identified in TOH1 have on competition in the PMI market in the UK. Further, the CC must undertake this analysis in the context of the prevailing legal framework which explicitly permits the controller of a NAF claim to retain any differential that exists between actual costs and the reasonable cost.

B.26 This will include the need to consider absolute overall costs as well as mark-ups – the most cost-efficient operators (i.e. those that procure repairs and TRVs at the lowest cost) are likely to have the highest mark-ups, but may well deliver lower overall repair costs than those who pass through at cost. This is because the existing legal framework incentivises insurers to pursue efficiencies, lowering overall industry costs.

B.27 Failure to address the underlying cost issues (including the role and impact of non-insurers intervening in the claims process) risks leading to unintended consequences (including potentially *increasing* upwards pressure on premiums).

B.28 We urge the CC to recognise the distinction between mark-up flows between insurers, which do not increase PMI premiums in aggregate, and leakage of mark-up to non-insurers, which result in higher underwriting costs and ultimately lead to higher premiums.

B.29 The core economic issue is not one of the costs of NAF claims in absolute terms; rather, the CC needs to identify and address the principal areas of market distortion which are driving up the costs for the industry as a whole whilst recognising that some industry operators are more efficient in delivering post-accident services than others.

B.30 We therefore believe that certain features of TOH1 may give rise to an AEC and that the CC should consider appropriate remedies, in light of the points identified above, to address the potential for consumer harm on TOH1.

[23] CC Working Paper 6, 'Theories of harm 1 and 2: Vehicle write-offs', paragraph 31.
[24] CC Working Paper 5, 'Theory of harm 1: Statistical analysis of claim costs'.

## C. Other Theories of Harm

C.1 As is clear from section B above, RSA continues to consider that substantially all of the issues in the PMI market that have the potential to cause consumer detriment are contained within TOH1 and we have therefore focused our response on that Theory of Harm. As regards the other Theories of Harm identified in the AIS, we believe that none of these gives rise to an AEC. Nevertheless, we set out below our additional comments on these.

**TOH2: Recipient of post-accident services being different from (and possibly less well-informed than) procurer of those services**

C.2 RSA agrees with the CC's provisional conclusion that there is no evidence of sub-standard repair quality or 'underprovision'. As regards the potential disadvantages and consumer harm the CC identifies from NAF customers failing to appreciate the implications of claiming under their own insurance[25] or their alternative options at the time of making a NAF claim[26], we consider that any issues relating to the transparency of dealings with customers, or customers not fully understanding the terms of their PMI policy, fall more clearly within the remit of the FCA and its ongoing work in these areas[27].

C.3 In particular, we have seen no evidence to support a finding that customers have concerns over the quality of repairs performed in insurer-managed repair networks. For our part, repairs conducted by RSA's authorised repair network are of high quality and deliver many additional customer benefits, including a lifetime guarantee on those repairs. This is a clear, identifiable benefit for customers choosing to make use of the RSA approved repair network and a significantly enhanced benefit to the five year warranties that were identified as 'typical' by the CC.

C.4 We welcome the CC's recognition of the legal principles that underpin entitlement to a TRV, including the requirement to assess need and (in respect of credit hire in particular), the need to consider whether the customer is impecunious. We do not consider that there are any issues with regard to underprovision of TRVs in respect of captured NAF claims and we look forward to commenting further on the CC's analysis after it has completed its review of call records.

*Conclusion on TOH2*

C.5 Accordingly, we agree with the CC's position that separate industry harm is unlikely to arise under TOH2. The core issues the CC needs to address are those identified by the CC in relation to TOH1. We therefore do not consider that the separate issues identified in TOH2 give rise to an AEC.

**TOH3: Horizontal effects (market concentration)**

C.6 RSA sets out below our comments on the three main issues identified by the CC under TOH3, namely those in relation to Northern Ireland ("NI"), price comparison websites ("PCWs") and repair cost estimation systems.

[25] For example, the need to pay an excess (at least in the short term), their NCB being (temporarily) affected, or their access to a TRV being shorter than needed in the case of a write-off.
[26] Working Paper 7, 'Theory of harm 2: Underprovision of repairs', paragraph 90.
[27] Issues around 'Treating Customers Fairly' ("TCF") and transparency are already being addressed at the point of sale by the FCA.

*Northern Ireland*

C.7 RSA agrees that there are features of the PMI market in NI that differ from the rest of Great Britain ("GB"). Nonetheless, with at least 17 PMI providers competing in a market around the size of Greater Manchester (and we note that in its hearing on 16 July AXA suggested there be as many as 38 insurers actively underwriting in NI), there remains significant choice for NI PMI consumers and we therefore question the CC's characterisation "*that PMI provision in NI is highly concentrated*"[28]. This high level of choice in NI is bolstered by additional cross-border competition (and potential competition) from insurers domiciled in the Republic of Ireland and GB.

C.8 Further, it is unclear whether the smaller number of players operating on the NI market relative to the rest of the UK has any bearing on the prices of PMI being higher in NI on average. As the CC acknowledges in its Working Paper, "*the price differential is also likely to be due to several other factors unrelated to concentration*"[29].

C.9 Moreover, as the CC also notes in its Working Paper, the NI market is predominantly broker-driven, i.e. the most common route to market in NI is the broker channel. Therefore, new entrants to the NI market (and, indeed, any of the existing 17 NI PMI providers) can partner with a local broker to obtain the requisite detailed market knowledge and access to broker customer lists to readily facilitate such new entry and expansion. Additionally, many brokers have some claims experience given the limited claims handling authorities extended to them by PMI providers already active in the market and, particularly when writing PMI on a panel basis, the pricing and claims information which would have been shared with them by PMI providers with whom they have an existing relationship.

C.10 This differs from the CC's suggestion in the AIS that "*a lack of market knowledge, which limited the ability of insurers to price risks accurately, placed smaller insurers or new entrants at a competitive disadvantage to the large incumbents*"[30].

C.11 We also have some concerns over the methodology adopted by the CC to consider profitability in NI[31]. For example, the CC's present analysis considers only claims ratios in NI relative to GB and does not consider overall profitability in absolute. As the CC has heard, claims ratios do not take account of distribution and expenses which, in a highly intermediated market like NI, are substantial. These higher distribution costs include commission payments to intermediaries and the costs of funding branches and face-to-face interaction with NI consumers.

C.12 Moreover, the CC's conclusions on PMI profitability in NI also differ from RSA's own experience in NI. We have found that our weighted average claims ratios are higher in NI than in GB[32] (and it would seem that this is the experience of three of the six larger insurers for whom the CC calculated weighted average claims ratios). We do not find this surprising given the higher cost of claims in NI due to the specific factors identified in our submissions and to which the CC makes reference in its Working Paper[33]. In fact, losses in NI supply of PMI are, for RSA, and possibly for other insurers, even greater than those observed for GB.

[28] CC Working Paper 10, 'Theory of harm 3: Horizontal concentration in PMI providers in Northern Ireland', paragraph 4.
[29] CC Working Paper 10, *ibid*, paragraph 9.
[30] AIS, paragraph 41.
[31] Set out at Appendix 1 of CC Working Paper 10, 'Theory of harm 3: Horizontal concentration in PMI providers in Northern Ireland'.
[32] RSA's average claims ratio in NI for 2008 – 2012 was [✂]% compared to the rest of the UK where our average equivalent claims ratio was [✂]%. See also RSA's Response to Additional Questions on Northern Ireland received from the CC on 4 June 2013, paragraph 1.2.
[33] RSA's response to Question 6 of the of the CC's Second Set of Follow Up Questions (June 2013) and Appendix 1 of CC Working Paper 10, 'Theory of harm 3: Horizontal concentration in PMI providers in Northern Ireland', paragraph 34(e).

We therefore have some concerns that the CC's conclusions on profitability in NI are not founded on the evidence presented in the WPs.

C.13 In any event, as we have set out in section B, we consider that the key focus for the CC should be on TOH1 – these are issues which pervade across the UK PMI landscape and we would be concerned if the CC's focus became distracted from TOH1.

*PCWs*

C.14 RSA agrees that PCWs have largely been a positive development for the PMI market by delivering greater choice, transparency and ultimately lower prices to consumers.

C.15 We also agree that the big 4 PCWs have some bargaining power over PMI providers but that horizontal concentration alone is unlikely to be a source of consumer detriment. We deal below with the issues arising out of the use of MFN clauses.

*Repair cost estimation systems*

C.16 RSA agrees with the CC that Audatex's increased market share is ultimately a reflection of its quality and with the CC's ultimate conclusion that no issues arise as a result of horizontal concentration among providers of repair cost estimation systems.

*Conclusion on TOH3*

C.17 Accordingly, we broadly agree with the CC's position on TOH3. However, we do not agree with the CC's characterisation of NI as being 'highly concentrated' and consider that the issues addressed under TOH1 should be considered across the UK PMI market.

**TOH4: Strategies to soften competition**

C.18 RSA sets out below our comments on the two main issues identified by the CC under TOH4, namely those in relation to add-ons and obstacles to switching.

*Add-ons*

C.19 RSA agrees that consumers appreciate the ability to pick and choose elements of their overall insurance policy – responding to this consumer demand was part of the driver for our introduction of eChoice, a dedicated website-only brand.

C.20 Nonetheless, as the CC recognises[34], the FCA is already taking numerous steps to protect consumers effectively in relation to add-ons, including in regard to any issues arising from a lack of transparency on, or consumers' understanding of, these products.

C.21 For instance, the FCA has recently confirmed, in July 2013, that it is continuing the market study into 'general insurance add-ons' initially announced by the FSA in December 2012. The FCA will also consider Motor Legal Expenses Insurance ("MLEI") in the context of this market study, having recently conducted a thematic review of that add-on.

C.22 Further, as the CC notes[35], in the FCA's TR13/1 Report, published in June 2013 following its MLEI thematic review, the FCA expressed the view that it was hard to see the practice of insurers selling MLEI add-ons on an 'opt-out basis' as consistent with good consumer protection. It asked firms to review their current practices in three specific areas to ensure they are meeting the needs of their customers, namely in relation to: (i) the basis on which

[34] AIS, paragraph 56 and CC Working Paper 13, 'Theory of harm 4: Analysis of add-ons', paragraphs 4 and 13-15.
[35] CC Working Paper 13, 'Theory of harm 4: Analysis of add-ons', paragraphs 13-15.

MLEI is provided; (ii) the quality of explanation of MLEI at all stages of the customer journey, including the claims process, with an emphasis on providing clear, appropriate information; and (iii) the extent of cover provided.

C.23 We do not agree with the suggestion from some quarters that the FCA review has disappointed by not delivering mandatory changes with more immediate deadlines to ensure add-ons are sold on an 'opt-in' basis. The FCA's TR13/1 Report on MLEI is written in no uncertain terms:

> "*The issues for firms to consider in the marketing of MLEI, and what changes this may require to their business practices, have been communicated clearly to them – whether through feedback meetings, the industry seminar, and this report."*
>
> "*The FCA will look again at the MLEI market in one year's time to assess the extent to which firms have improved their marketing. At that time firms that have not amended their business practices will stand out and are likely to face further regulatory action."*
>
> "*Firms need to be able to give a clear account of the nature of the review they have undertaken and the reasoning for any decision, particularly if this is not consistent with the general industry direction of travel – for instance, in the retention of opt-out selling or providing sales incentives heavily geared to the selling of MLEI and other add-ons*[36]*.*"

C.24 Moreover, the FCA has already shown a strong intent to pursue branded brokers and insurers that have prioritised profits over the interests of consumers with regard to add-on policies. For example, the FCA recently fined Swinton Group Limited almost £7.4 million for failing to treat over 650,000 customers fairly when selling monthly add-on insurance policies. Following this fine, esure's house broker announced that it has cut both profit and revenue forecasts over fears that the FCA's regulatory regime will not look favourably on their historic practice of selling opt-out bundled add-ons.

C.25 Accordingly, issues around TCF and transparency are already being addressed at the point of sale by the FCA and the FCA's enforcement action is already resulting in a change of behaviour on add-ons, namely a move from an 'opt-out' to an 'opt-in' system.

C.26 Moreover, we do not consider add-ons to be an issue affecting competition or in any way responsible for wider dysfunction in the market; rather, this is a point of sale issue that falls more squarely in the FCA's remit.

C.27 In light of the above, we believe the FCA is best placed to continue its work on add-ons and to address any market and consumer awareness concerns arising from its market study and related thematic reviews in this area. In particular, it is clear that the practice of selling add-ons on an 'opt-out' basis is being specifically addressed and that the FCA intends to review the position again next year.

C.28 RSA urges the CC to avoid any duplication or inconsistent outcomes between its own review and those being carried out by the FCA.

*Obstacles to switching*

C.29 RSA welcomes the CC's recognition of clear evidence of high levels of switching for PMI relative to comparable products. We also agree and support the conclusions that automatic renewals and cancellation fees do not operate as barriers to switching.

[36] FCA's TR13/1 Report, June 2013, section 5 (Follow-up actions), paragraphs 5.1 - 5.3.

C.30 Moreover, as the CC notes in its Working Paper 14, 'Theory of harm 4: Obstacles to switching', the FCA is already reviewing some of the CC's candidate obstacles to switching and is also under a general requirement to ensure that industry participants treat customers fairly[37]. These factors ensure that the FCA is best placed to consider any barriers to switching that might conceivably arise in future (whether in relation to automatic renewals, cancellation fees, NCB protection[38] or otherwise).

C.31 Given the high levels of switching identified (an earlier OFT study found that 61% of PMI customers had switched in the past five years, the highest rate of switching identified by the OFT), we agree with the CC's conclusion not to consider obstacles to switching further.

*Conclusion on TOH4*

C.32 We broadly agree with the CC's position on TOH4 with the caveat that the CC must be careful to avoid any duplication or inconsistent outcomes between its own review of add-ons and those being carried out by the FCA.

**TOH5: Vertical relationships**

C.33 RSA sets out below our comments on the four main issues identified by the CC under TOH5, namely those in relation to PCW integration, MFN clauses, foreclosure issues and non-foreclosure issues (paint product mandating).

*PCW integration*

C.34 RSA agrees with the CC's findings on PCW integration.

*MFN clauses*

C.35 In general, RSA considers that narrow MFNs can be a useful way for consumers to compare premiums and PMI policies with confidence. In contrast, wide MFNs have a greater potential to lead to anti-competitive effects and hence ultimately consumer detriment.

C.36 We are, however, concerned about two negative effects that may arise as a result of any MFN clause:

(i) The impact of MFNs will be to keep insurers' web-based prices artificially high since the price quoted by an insurer on its own website can be no lower than the highest price quoted for that insurer on any PCW[39] (thus removing insurers' freedom to price on an important channel preferred by large groups of consumers); and

(ii) MFNs have the potential to stifle innovation aimed at reducing PMI premiums (for example, PCWs would not see any direct benefit to their market shares from improving their fraud detection or from enabling the more accurate pricing of risks)[40].

C.37 We look forward to commenting further once the results of the CC's assessment of potential efficiency gains arising from MFNs is available.

---

[37] CC Working Paper 14, 'Theory of harm 4: Obstacles to switching', paragraphs 19 and 22.
[38] If there is any existing customer confusion on NCB and NCB protection, this is not an issue affecting competition and we consider the FCA best placed to deal with this issue.
[39] The CC has recognised this effect in CC Working Paper 16, 'Theory of harm 5: Impact of MFN clauses in contracts between PCWs and PMI providers', paragraphs 50-52.
[40] The CC has recognised this effect in CC Working Paper 16, *ibid,* paragraph 11(c).

*Foreclosure issues*

C.38 RSA agrees with the CC's position on foreclosure issues and has no further comments on this.

*Non-Foreclosure issues (paint product mandating)*

C.39 RSA notes that the CC has drawn a distinction between non-exclusive contracts between paint manufacturers and insurers (under which insurers *recommend* a paint brand and/or distributor but where repairers are free to use alternative brands of paint) and exclusive contracts (under which insurers *mandate* the use of a paint brand and/or distributor)[41]. This is an important distinction, with the latter giving rise to potentially greater harm than the former (notwithstanding the CC's eventual finding on the exclusive contract it considered). As the CC is aware, RSA operates a non-exclusive contract model, through its repairer business RSA Accident Repairs (known as "RSAAR").

C.40 In the context of whether such non-exclusive contracts lead to an increase in the billed cost of paint, the CC rightly points to the fact that the price of paint is not determined by reference to such contracts but, rather, is typically determined by reference to the Audatex 'weighted average paint price'[42]. We note the CC's findings that the cost of paint to repairers is typically between 20 – 40% of the Audatex weighted average (around £80 - £90), whilst insurers are usually charged between 70 – 80% (around £200 - £350) of this price[43]. This demonstrates that by far the greater proportion of over-costing in relation to paint is occurring at the repairer, rather than the insurer, level.

C.41 Indeed, we note the evidence referred to in the CC's Working Paper that repairers face only slightly higher paint costs (of around only 1.5% of the total cost of a repair) as a result of non-exclusive contracts between insurers and paint manufacturers[44]. (The CC's assessment suggests further that even the exclusive contract it considered did not lead to a greater degree of overcosting[45].) We therefore agree with the CC's overall conclusion that consumer harm is unlikely to arise directly from non-exclusive contracts[46]. In our view, any residual concerns the CC may have regarding possible indirect harm to customers as a result of these contracts inflating NAF repair costs are therefore best addressed by the CC as part of the overall costs of repairs and the related issues identified by the CC in TOH1.

C.42 Moreover, we strongly believe that rebate-generating contracts with paint suppliers *do* produce efficiency gains since they enable insurers, as bulk purchasers, to use their bargaining power in a way that individual garages and individual repairers, who have significantly less bargaining power, would not be able to do[47]. Rebates therefore represent a mechanism by which insurers can realise the value of the bargaining power they derive from their purchase volumes.

C.43 The CC notes that, if insurers are not successful in extracting, through rebates, all of the additional revenue they receive from the higher paint cost charged to repairers (i.e. some of this additional revenue ends up with paint suppliers), then paint supply contracts are unlikely to be beneficial to PMI consumers overall as there is likely to be some 'leakage' of

[41] CC Working Paper 17, 'Theory of harm 5: Analysis of vertical agreements for the supply of paint (excluding foreclosure)', paragraph 4 *et seq*.
[42] *Ibid*, paragraph 15.
[43] *Ibid*, paragraph 17.
[44] *Ibid*, paragraph 5.
[45] *Ibid*, paragraph 8.
[46] *Ibid*, paragraph 63.
[47] The CC recognises that non-exclusive paint supply contracts may generate efficiencies and that some of these might result in reduced costs for consumers. See CC Working Paper 17, 'Theory of harm 5: Analysis of vertical agreements for the supply of paint (excluding foreclosure)', paragraph 62.

value to paint suppliers, and claims costs overall are likely to have risen[48]. In fact, in the absence of rebates, there would be no incentive for insurers to enter into paint supply contracts with the paint manufacturers at all. This would leave the negotiation of terms in the hands of repairers who, lacking the bargaining power possessed by insurers, would be ill-equipped to achieve the favourable terms insurers can obtain. In this way, the benefit of bulk purchasing would be lost to the industry, leading to higher paint prices (and, therefore, repair costs), to the benefit only of the paint manufacturers at the expense of PMI customers.

C.44 In contrast, under rebate-generating paint supply contracts, the consequent reduction in repair costs achieved by insurers as a result of their bargaining power can be expected to be passed on to consumers via lower PMI premiums[49].

*Conclusion on TOH5*

C.45 Accordingly, we agree with the CC's position on TOH5 with the caveats that: (i) while MFNs can be a useful way for consumers to compare premiums and PMI policies with confidence, there are also negative effects arising from the use of MFN clauses (including keeping insurers' web-based prices artificially high and stifling innovation); and (ii) any residual CC concerns on possible indirect harm from paint supply contracts are best addressed by the CC under TOH1.

[48] CC Working Paper 17, 'Theory of harm 5: Analysis of vertical agreements for the supply of paint (excluding foreclosure)', paragraph 55.

[49] This cost saving contributes to the overall underwriting result (and also compensates, to some degree, for the over-charge for paint at the repairer level) which in turn assists insurers to lower PMI premiums for customers.

## D. Possible Solutions

D.1 In our response to the Issues Statement, RSA set out one possible solution aimed at placing downwards pressure on the level of 'reasonable' costs when providing TRVs to claimants. The focus was on TRVs as this was the area RSA had identified as giving rise to the greatest mark-ups and the area where insurers faced the greatest intervention from third parties seeking to capture (and retain) that mark-up. The CC has also identified that the mark-ups on TRVs are significantly greater than those identified for repair and/or total loss (around three times greater than each and around 50% greater than both combined.

D.2 This conclusion is supported by the analysis at Confidential Annex 2 which confirms that the potential for consumer harm is far greater in respect of the provision of TRVs, not only because the mark-up is significantly greater than that identified for repairs or total loss, but also because a significant proportion of this mark-up is retained by non-insurers. In other words, the 'leakage' problem is far greater in respect of TRVs.

D.3 Overall, Annex 1 estimates that aggregate leakage in respect of TRVs is between £90 million and £170 million per annum, significantly higher than the £15 million to £25 million estimated leakage on credit repairs.

D.4 Given the above, RSA considers it logical for the CC to focus attention on addressing the issues in respect of TRVs. With that in mind, we have set out below some further thoughts on the desired outcomes and our comments on possible solutions in the light of the AIS.

*Desired Outcomes*

D.5 RSA would like to see the outcome of the CC's PMI market investigation give rise to a comprehensive solution which:

(i) Protects the NAF customer's right to full rectification;

(ii) Maintains and enhances the customer experience, including the speed of claim, and reduces the scope for disputes;

(iii) Aligns the incentives of the party controlling costs (i.e. the procurer of services) with the party ultimately responsible for paying for those services (i.e. the AF insurer); and

(iv) Reduces overall costs, whilst protecting and strengthening incentives on insurers to operate as efficiently as possible to ensure that savings can be passed through to customers in the form of lower premiums.

*Mandatory NAF Mobility Cover*

D.6 As previously outlined in RSA's response to the CC's Issues Statement[50], RSA believes that one possible solution would be to make a relatively simple change to the minimum levels of insurance cover required in the UK, making it a requirement for all insurance policies to expressly include mandatory like-for-like NAF mobility cover for all policyholders.

D.7 In other words, a NAF driver's existing entitlement to a like-for-like TRV as a matter of common law would become enshrined as a policy benefit such that their insurer would be directly and contractually responsible for providing the like-for-like TRV. This would entail a legal or regulatory requirement for policies to set out exactly how the customer's mobility cover entitlement would be provided by their insurer in the event of the customer suffering a

[50] Section C.

NAF accident (with insurers remaining free to compete on service level and quality). This could have a significant impact on reducing unnecessary costs in the provision of TRVs to NAF drivers after an accident.

D.8 Car hire companies, including credit hire companies, would continue to compete to be the provider of mobility solutions to PMI providers, who in turn would continue to be incentivised to procure these services at the lowest cost. In turn, the solution could be worked to ensure that it has a significant constraining effect on the charges that could ultimately be recovered.

D.9 In summary, the mandatory NAF mobility cover proposal would:

(i) Require a change in the legal minimum levels of insurance cover, ensuring that like-for-like TRVs are required in the event that a NAF customer's vehicle is off the road as a result of an incident involving two or more vehicles;

(ii) Provide TRVs in accordance with the policy terms - as the like-for-like TRV becomes a legal (and hence contractual) entitlement;

(iii) Confer on the NAF insurer control over the customer service element of providing a TRV to its NAF customer;

(iv) Require changes to ensure earlier agreement on liability, removing or significantly reducing any credit risk for customers and/or the TRV provider; and

(v) Place downwards pressure on the 'reasonable' cost of providing TRVs, ensuring greater control on costs ultimately subrogated to AF insurers.

D.10 By establishing a lower benchmark for TRV costs, significant downwards pressure would be applied to the ‘reasonable’ cost of mobility solutions for NAF claims. This should also ensure that the cost of NAF cover ultimately subrogated back to the AF insurer is capped at a reasonable level (thereby ensuring the AF insurer's ability to control costs). A mandatory NAF mobility solution may in addition serve to reduce frictional costs, which would also ultimately feed through to lower premiums. Similar principles could also assist in lowering costs related to NAF repairs and claims.

*Conclusion*

D.11 RSA looks forward to working with the CC in the next phase of the investigation with a view to developing lasting and comprehensive market solutions in consultation with both the FCA and consumers.

RSA

**Neville Howe**

**General Counsel, UK & Western Europe**

# Economic analysis of mark-ups on subrogated NAF claims

**RBB Economics, 00 XXX 0000**

## 1. Introduction

This paper, prepared at the request of RPC, counsel to RSA, provides an economic assessment of the impact of mark-ups observed on the subrogation of not at fault ("NAF") claims within the PMI industry. The paper considers the impact of the reasonable mark-up on NAF claims permitted by law, referred to by the Competition Commission ("CC") as "overcosting", focusing on the flow of those mark-ups between industry participants and the impact on consumers.

We establish and discuss three important points concerning the operation of the PMI industry under the prevailing legal framework:

- First, we use a simple model of PMI costs to demonstrate that the mark-ups on NAF claims permitted by law cannot be assumed to lead to higher PMI premiums or to consumer detriment.

- Second, we discuss the beneficial impact of the legally permitted mark-ups on efficiency incentives, and the potential adverse consequences for consumers of removing those mark-ups (i.e. the potential for consumer detriment arising from subrogation at cost).

- Finally, we demonstrate that the prevailing legal framework may result in upward pressure on PMI premiums via "leakage" where non-insurers are involved in NAF claims and are able to capture the available mark-up at the expense of consumers. Using evidence from the CC's market investigation we estimate that this leakage amounts to between £105 million and £190 million per annum across the PMI industry.

In so doing, this paper refutes two comments made by Allianz during the multi-party hearing of 16 July that we believe do not properly reflect the economics of the PMI industry and the reasonable mark-ups on NAF claims.

First, Allianz claimed that the overcosting identified by the CC can "only be funded from one source: premium increases".[1] We explain below that this statement fails to account for the flow of reasonable mark-ups on NAF claims between insurers. While the existence of reasonable mark-ups increases marginal costs for at fault ("AF") insurers, which would tend to place upward pressure on PMI premiums, those mark-ups also reduce marginal costs for NAF insurers, which would tend to place downward pressure on PMI premiums. Using a simple model of underwriting costs that accounts for the fact that each insurer will in some cases be AF and in some cases NAF, we demonstrate that, absent the intervention of non-insurers, these two effects will tend to offset one another such that there is no net impact on PMI premiums.

Second, Allianz suggested that the CC should consider mandating subrogation of NAF PMI claims at actual cost, prohibiting the various models (vertical integration, rebates, referral fees) used by NAF insurers to capture reasonable mark-ups.[2] We argue that not only is this unnecessary, given that reasonable mark-ups need not place upward pressure on PMI premiums, but also that the use of actual, rather than reasonable, costs may have the unintended consequence of removing insurers' incentives to pursue cost efficiencies, leading to *higher* PMI costs and premiums.

The paper is structured as follows. Section 2 sets out our core argument, which is that the reasonable mark-ups observed on NAF claims represent not only a marginal cost for AF insurers but also an offsetting benefit for NAF insurers that, in effect, *lowers* marginal cost. In the context of a stylised model of PMI supply costs, we demonstrate that, in the absence of non-insurer intervention, these two effects offset each other exactly. As such, reasonable mark-ups bring about no overall increase in underwriting marginal costs across the industry, and therefore do not increase PMI premiums in aggregate.

The remainder of the paper extends this analysis to consider the practical implications of the prevailing legal framework for NAF claim recovery.

Section 3 considers a potential benefit of the prevailing legal framework, which is the clear incentive that it generates for insurers to pursue efficiencies in the provision of TRV and repair

[1] Competition Commission – Notes of a hearing with Association of British Insurers, Ageas UK, Allianz, Zurich, Liverpool Victoria & RSA held at Competition Commission, Southampton Row, London on Tuesday 16 July 2013, page 16, line 6.

[2] Competition Commission – Notes of a hearing with Association of British Insurers, Ageas UK, Allianz, Zurich, Liverpool Victoria & RSA held at Competition Commission, Southampton Row, London on Tuesday 16 July 2013, page 41, lines 7 to 9.

services. Because the law permits entities controlling NAF claims to retain any margin between the reasonable and actual cost of providing services to NAF claimants, there is an incentive for firms to procure those services as efficiently as possible. By contrast, a system of subrogation at actual cost, such as proposed by Allianz, would create no incentive to minimise the cost of procuring services for NAF claims, as claims controllers would be able to impose their own inefficiency on AF insurers. Specifically, we demonstrate that subrogation at cost benefits inefficient insurers at the expense of efficient insurers and thereby, all else equal, creates a powerful incentive to operate *inefficiently*.

Section 4 considers the impact of non-insurer intervention in the management of NAF claims. We demonstrate that where the reasonable mark-up on NAF claims is captured by non-insurers, the value of that mark-up will not be passed back to PMI consumers via downward pressure on premiums, but will instead leave the industry via a process that we term “leakage”. This leakage may occur due to non-insurers capturing control of NAF claims, or via their involvement in NAF claims acting on behalf of insurers. By breaking the equivalence between the benefit to NAF insurers of reasonable mark-ups and the cost to AF insurers of reasonable mark-ups, this leakage generates net upward pressure on PMI premiums. Applying the CC’s evidence on the value of reasonable mark-ups on TRV and repair claims to our illustrative model of NAF costs we find that total leakage across the PMI industry on NAF claims in which non-insurers are involved may be between £105 million and £190 million.

## 2. Transfer of NAF mark-ups between insurers

The Competition Commission has in its annotated issues statement and accompanying working papers identified what it refers to as “overcosting” relating to the supply of TRV and repairs on NAF claims. Specifically, the CC has suggested that NAF TRV claims include a mark-up in excess of £600, while NAF repair costs include an average mark-up of c.£200 when undertaken by insurers and c.£400 in the case of credit repairs.

As set out in the accompanying annex “Quantification of overcosting of TRV and repair services”, RSA broadly agrees with the magnitude of the TRV and repair mark-ups on NAF claims identified by the CC.

The CC attributes these overcharges to the “moral hazard” that exists when one insurer provides or procures services that will be funded by another.[3] RSA’s view is that these mark-ups reflect the well-established legal principle that NAF claimants (or entities acting on their behalf) are permitted to recover the reasonable cost of rectification services provided to a NAF policyholder, equivalent to the cost that the policyholder would have paid for those services, rather than that actual cost incurred.[4] This legal principle permits insurers and non-insurers acting for NAF claimants to generate and retain a reasonable mark-up on NAF claims. We

[3] See, for example, the Competition Commission’s Annotated Issues Statement, 5 July 2013, paragraph 27.

[4] See Royal & Sun Alliance Insurance Plc - Response to Annotated Issues Statement and Working Papers, paragraph B.2 and footnote 7.

would not, therefore, refer to "moral hazard" in this context; instead we refer throughout this paper to a "reasonable mark-up" (permitted by law).[5]

This section sets out a stylised framework for understanding the potential impact of the reasonable mark-up permitted by law on NAF claims. The main insight is that reasonable mark-ups on NAF claims represent an increase in marginal cost to AF insurers, but a decrease in marginal cost to NAF insurers. Consequently, while reasonable mark-ups place upward pressure on PMI pricing in respect of AF customers, they also place downward pressure on PMI pricing in respect of NAF customers.

## 2.1. A stylised model of marginal cost under subrogation at cost and reasonable mark-up regimes

At the point of setting PMI premiums, insurers do not know whether a particular consumer will make an AF, NAF or no claim over the life of that policy. In assessing the costs of supplying PMI, insurers will therefore take into account not only the cost of the reasonable mark-up in the event that customers make an AF claim, but also the benefit of the reasonable mark-up in the event that customers make a NAF claim.

This principle can be demonstrated and explored more formally in the context of a simple economic model of insurers' marginal costs for underwriting PMI policies. In the short term, it is the marginal cost of supplying insurance policies to consumers that will determine the pricing of those policies.[6] In particular, insofar as one NAF claims cost recovery scheme yields higher marginal costs for insurers than another, so that scheme will result in higher prices to consumers, all else being constant, and *vice versa*.

For illustrative purposes we discuss a highly stylised scenario, although this does not detract from the more general validity of the point being made. Specifically, we make the following two assumptions that allow us to focus on the salient elements of NAF claims cost recovery.

First, all policyholders are involved in one accident over the course of their policy and all accidents are the same, with the following characteristics: (i) two parties are involved – one clearly AF, the other clearly NAF; (ii) there is no damage to the AF driver's car; (iii) the NAF driver's claim can be rectified at an actual cost of *A*.

Second, the marginal cost of underwriting an insurance policy comprises two elements: the expected cost of the consumer in question being involved in an AF accident, and the expected cost of the consumer in question being involved in a NAF accident. For simplicity we assume that all other marginal costs (for instance policy administration) are equal to zero.

---

5 Indeed, in the context of insurance, moral hazard usually has a very different meaning. It is typically thought of as the idea that once insured, an individual may take on greater risk. For example, a person that has his or her bike insured may be less careful regarding where that bike is left unattended since if the bike is stolen an insurance claim can be made.

6 In the longer term, given the competitive nature of the supply of private motor insurance, reductions in fixed costs may be passed through in lower premiums (and, conversely, higher fixed costs may lead to higher premiums).

In this section we also make the third assumption that NAF claims are always controlled by the NAF insurer. This assumption is relaxed in section 4.

We now define $c$ as the marginal cost of underwriting a policy, $p$ as the probability that the policyholder is AF during the policy lifetime, and $(1-p)$ as the probability that the policyholder is NAF.[7]

$$\boldsymbol{c = p(cost\ of\ AF\ claim) + (1 - p)(cost\ of\ NAF\ claim)}$$

**Subrogation at actual cost.** Let us first consider the case of no margin being applied to NAF claims costs. This represents a base case against which we can compare the prevailing legal framework, i.e., where reasonable mark-ups are permitted. The marginal cost to an insurer of underwriting any given customer in this scenario is given by:

$$\boldsymbol{c^{actual\ subrogation} = pA + (1 - p) * 0 = pA}$$

That is, the AF insurer must pay A in the event that its customer is AF in a multi-car accident, and zero otherwise.

**NAF insurer subrogates at reasonable cost.** The second scenario to consider is one corresponding to the prevailing legal framework in which the entity managing a NAF claim is permitted to recover the reasonable, rather than actual, costs of that claim from the AF insurer. For present purposes we assume that the entity controlling NAF claims and so receiving the reasonable mark-up is the NAF insurer; this assumption is relaxed in section 4. In this case, defining the reasonable cost of the NAF claim as $R$, the marginal cost of underwriting a policy is given by:

$$\boldsymbol{c^{reasonable\ subrogation} = pR - (1 - p)(R - A)}$$

In the above expression, $pR$ is the cost to the insurer of its policyholder being AF, which is the probability of that event, $p$, multiplied by the amount the insurer pays in that event, $R$. The term $(1-p)(R-A)$ is the benefit to the insurer of its policyholder being NAF, given by the probability that the policyholder is NAF, $(1-p)$, multiplied by the available margin obtained by controlling the NAF claim, $(R-A)$.

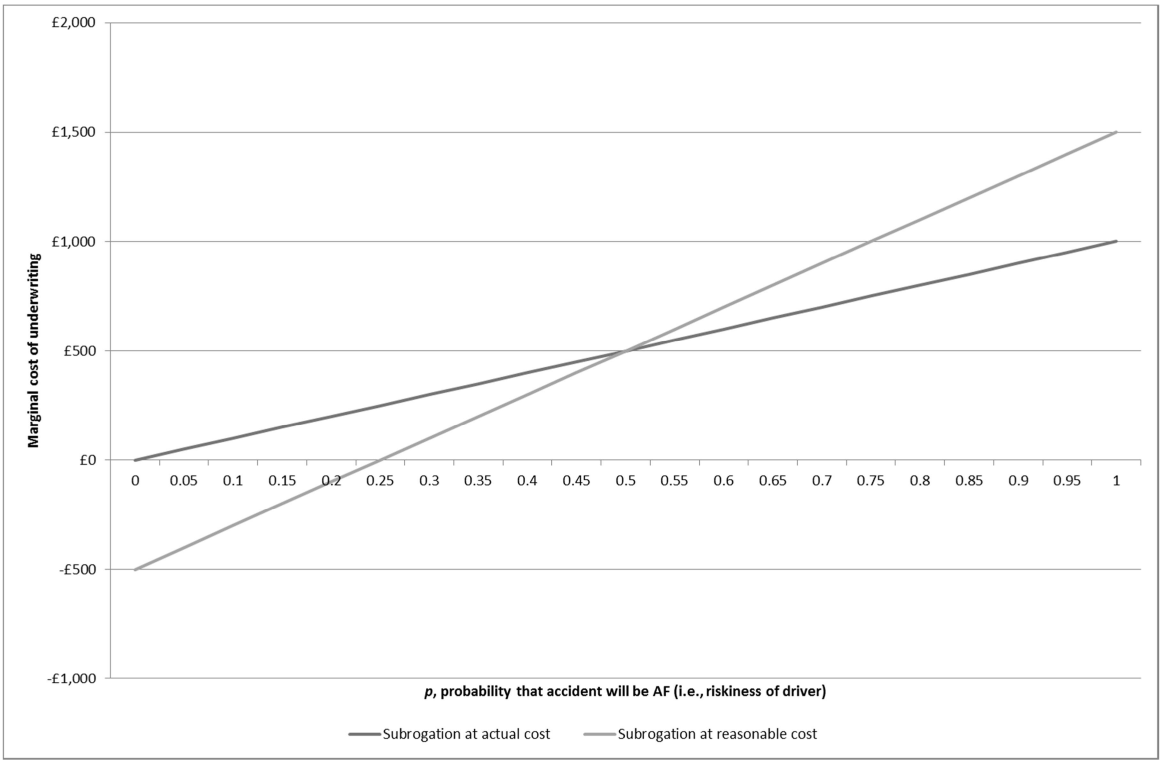
The second term is *subtracted* from the first term making the marginal cost smaller. Intuitively, while it is costly for the insurer when its policyholder is AF, in the event that the policyholder is NAF the insurer earns a reasonable mark-up (i.e., rather than incurring a cost, the insurer generates a revenue), which can be thought of as a "negative marginal cost". This negative marginal cost gives insurers an incentive to reduce PMI premiums in order to increase the number of customers served so as to benefit from the reasonable mark-up that can be earned on those customers that make NAF claims.

---

[7] Note that the probability of being NAF is equal to one minus the probability of being AF because we have assumed that all policyholders are involved in one multi-car accident over the life of their policy. This assumption is equivalent to excluding from the analysis those consumers not involved in such an accident, for which the marginal costs have been normalised to zero.

The following chart summarises the marginal cost of underwriting under each of the above scenarios for alternative values of *p* and illustrative values of *A* and *R*.

**Figure 1: Expected marginal cost of underwriting motor insurance policy under subrogation at actual and reasonable cost (*A*=1000, *R*=1500)**




*Source: RBB calculations.*

This chart illustrates three important points.

First, it can be seen that the two marginal cost schedules intersect in the case of *p*=0.5. For consumers equally likely to be involved in AF and NAF claims, the insurer's marginal cost of underwriting a policy is equal to 0.5*A* under both schemes. That is, where consumers are equally likely to be found AF and NAF, the marginal cost of insuring a driver is no different under the prevailing legal framework from the situation in which there is no mark-up on actual claims costs.

Second, insofar as insurers are able to observe consumers' relative propensity to be involved in AF and NAF incidents, the prevailing legal framework does have a distributional effect. The fact that insurers benefit from the reasonable mark-up on NAF claims but bear the cost of that mark-up on AF claims means that the expected marginal cost of serving customers likely to be involved in AF claims (high values of *p*) is higher for subrogation at reasonable cost than for subrogation at actual cost; conversely, for those whose claims are likely to be NAF (low values of *p*), the expected marginal cost is lower under subrogation at reasonable cost than under subrogation at actual cost. This cost pattern will feed through into pricing incentives, meaning that under the prevailing legal framework insurers will tend to offer higher PMI premiums to high-risk drivers than they would under a subrogation at cost model, but would have the incentive to offer lower premiums to low-risk drivers.

Third, it can be seen from the fact that the marginal cost schedules for the two subrogation schemes are linear and cross at $p$=0.5 that insurers' total marginal costs across a uniform distribution of risks (i.e., one in which any value of $p$ between 0 and 1 is equally likely) are equal under both schemes.[8] That is, notwithstanding the differing distribution of marginal costs by risk level, the higher marginal costs on AF customers under the prevailing legal framework due to reasonable mark-ups are exactly offset by lower marginal costs on NAF customers. Consequently, the overall level of insurers' expected marginal costs and therefore PMI pricing is no different to the overall level that would occur under subrogation at cost.

### 2.2. Summary and wider implications

In summary, a simple model of the PMI industry as comprising only AF and NAF insurers shows that subrogation at reasonable cost under the prevailing legal framework has no net effect on the level of costs within the industry. The additional marginal cost of AF claims is offset by an equal benefit (which reduces the marginal cost) on NAF claims. Within a closed industry comprising only insurers, and where NAF insurers capture all NAF claims, the legally permitted mark-ups identified by the CC flow between insurers but have no aggregate effect on premiums (although there are distributional effects in favour of lower risk drivers).

The stylised model thus demonstrates that Allianz is incorrect to state that the reasonable mark-ups permitted by law could "only be funded from one source: premium increases".[9] By focusing only on the cost to AF insurers of reasonable mark-ups on NAF claims, Allianz fails to account for the offsetting benefit of those mark-ups for NAF insurers.

## 3. Efficiency incentives

The preceding section took the absolute rectification cost as given and established that the reasonable mark-up on NAF claims permitted by law does not represent excess pricing to the benefit of insurers and at the expense of consumers, but may be expected to have no net impact on PMI premiums. In this section we allow rectification costs to vary. We demonstrate that such mark-ups may in fact have a positive impact on consumers by incentivising insurers to pursue efficient provision of TRV and repair services.

The prevailing legal framework permits the entity controlling NAF claims to retain any margin between the actual cost of providing rectification services and the reasonable cost that the NAF policyholder would have paid for those services. While the value of the reasonable cost for

---

[8] Formally, in this example with a uniform distribution, the definite integral of $c^{reasonable\ subrogation}$ and $c^{actual\ subrogation}$ over values of p from 0 to 1 is equal to A/2.

[9] Competition Commission – Notes of a hearing with Association of British Insurers, Ageas UK, Allianz, Zurich, Liverpool Victoria & RSA held at Competition Commission, Southampton Row, London on Tuesday 16 July 2013, page 16, line 6.

rectification services is outside the control of the entity controlling the NAF claim, the claim controller can influence the value of the reasonable mark-up that it earns by minimising the actual cost of the rectification services. The lower the actual cost it incurs in providing rectification services to the NAF consumer, the greater the margin between reasonable and actual cost. Consequently, the controllers of NAF claims, irrespective of their identity, have an incentive under the prevailing legal framework to provide rectification services to NAF policyholders in the most efficient manner possible.

By contrast, in the alternative scenario of subrogation at cost, the controllers of NAF claims would have no incentive to pursue efficiencies in providing rectification services to NAF policyholders. The NAF claim controller will bear the actual cost of TRV and repair services provided and receive a payment from the AF insurer equal to that actual cost, therefore earning zero margin regardless of the value of the actual cost. A subrogation at cost model, such as that apparently advocated by Allianz, would therefore be expected to result in less pressure to pursue efficiencies in NAF rectification services, and therefore higher costs for those services.[10]

Subrogation at reasonable cost also has the desirable property of conferring a competitive advantage on more efficient insurers, a property that is not present in the case of subrogation at actual cost. Because the principle of subrogation results in insurers bearing one another's costs, a NAF subrogation at cost model results in a perverse outcome whereby low cost insurers subsidise high cost insurers, while high cost insurers are able to penalise low cost insurers. Thus, subrogation at cost reduces the competitiveness of efficient insurers, while improving the competitive position of inefficient insurers.

This point can be demonstrated with a modification of the illustrative model set out in section 2. Again, we consider marginal underwriting costs for insurers under subrogation at actual cost and subrogation at reasonable cost. In this case, however, we allow for differences in insurer efficiency by assuming that there are two insurers, an efficient insurer that can rectify claims at low actual cost *L*, and an inefficient insurer that can rectify claims at high actual cost *H*.

In this scenario, the two insurers' PMI underwriting costs are given as follows (these expressions follow those in section 2 with actual costs *A* replaced by low actual cost *L* and high actual cost *H* as appropriate).

[10] Note that where NAF claims are controlled by insurers, those insurers would have an incentive to pursue efficiencies in the procurement of rectification services for which they will ultimately bear the cost, such as captured NAF claims and single vehicle accident claims. There may be a spillover between TRV and repair procurement efficiencies achieved in these areas and NAF claims. However, there will be no incentive to pursue efficiency in the rectification of subrogated NAF claims, and therefore a lower overall incentive to achieve efficiencies than under the prevailing legal framework.

**Table 1: Aggregate marginal cost expressions**

| | Subrogation at actual cost | Subrogation at reasonable cost |
|---|---|---|
| **Efficient insurer** | $\boldsymbol{c = pH + (1-p) * 0}$ | $\boldsymbol{c = pR - (1-p)(R-L)}$ |
| | $\boldsymbol{= pH}$ | $\boldsymbol{= R(2p-1) + (1-p)L}$ |
| **Inefficient insurer** | $\boldsymbol{c = pL + (1-p) * 0}$ | $\boldsymbol{c = pR - (1-p)(R-H)}$ |
| | $\boldsymbol{= pL}$ | $\boldsymbol{= R(2p-1) + (1-p)H}$ |

*Sources: RBB calculations.*

The first column shows that under subrogation at actual cost each insurer faces a marginal cost defined by the other insurer's level of efficiency, such that the efficient insurer has high costs and the inefficient insurer low costs. The second column shows that under subrogation at reasonable cost, each insurer faces a marginal cost given by the (common) reasonable cost and its own level of actual cost. In this scenario, the efficient insurer has lower marginal costs than the inefficient insurer, and so will enjoy a competitive advantage in the supply of PMI premiums. This reinforces the incentive under reasonable subrogation for insurers to pursue efficiency in TRV and repair services, an incentive that is absent under actual subrogation.[11]

Importantly, the level of efficiency in the rectification of NAF claims feeds through to PMI premium pricing via its impact in the marginal cost of underwriting. The simple model of PMI underwriting marginal costs set out at section 2 shows that the average marginal cost across the population of consumer risks is equal to $A/2$, irrespective of whether NAF insurers subrogate claims at actual or reasonable costs.[12] That is, the level of PMI underwriting marginal cost (and therefore pricing) depends not upon the cost at which NAF claims are subrogated between insurers but on the actual cost at which those claims are resolved. It therefore follows that efficiency improvements in the actual cost of resolving NAF claims feed through to lower PMI premiums, while inefficient rectification of NAF claims, as would arise under actual cost subrogation, will result in higher PMI premiums, all else being constant.

Consequently, by incentivising NAF claims controllers to pursue efficiencies in NAF claims rectification the prevailing legal framework leads to lower industry costs, and therefore lower PMI premiums, than would be the case under a subrogation at cost model. Allianz's apparent suggestion that NAF subrogation be restructured in order to prevent insurers from benefitting

---

[11] Note that, by focusing on NAF claim costs only, our illustrative model does not capture the impact of efficiency on insurers' rectification costs for their own policyholders on AF claims. In this respect, inefficient insurers will be penalised and efficient insurers rewarded by their own cost levels, mitigating to some extent the effect established in the text. The conclusion that more efficient insurers enjoy a greater competitive advantage over inefficient insurers under reasonable cost subrogation than under actual cost subrogation applies more generally however.

[12] Recall that the model presented abstracts from single vehicle accidents and any administrative costs, and also assumes that each consumer will be involved in one incident per year; the actual value of $A/2$ should therefore be regarded only as an illustration of the general proposition that reductions in $A$ will feed through to lower underwriting marginal cost and therefore lower premiums.

from reasonable mark-up on NAF claims could therefore be expected to harm dynamic incentives, and to lead to inefficiency, higher costs and ultimately higher PMI prices.

# 4. Leakage due to the intervention of non-insurers

Section 2 considered the flow of reasonable mark-ups on subrogated NAF claims within a closed industry in which NAF claims were controlled by the NAF insurer, demonstrating that in such cases the reasonable mark-up permitted by law will not lead to higher PMI premiums. In this section we extend the analysis to consider the effect on non-insurer intervention. This allows us to demonstrate formally the argument set out by RSA that where non-insurers, such as CMCs, control NAF claims, the value of the reasonable mark-up permitted by the prevailing legal framework "leaks" from the industry, leading to higher premiums.[13]

We adapt the simple model presented in section 2 to consider two forms of non-insurer intervention in the claims process. First, section 4.1 considers the flow of funds when non-insurers acquire control of NAF claims and are consequently able to extract the reasonable mark-up permitted by law. Second, section 4.2 considers the scope for leakage in the scenario in which non-insurers are appointed by insurers to provide TRV and repair services in respect of NAF claims. Section 4.3 summarises these findings and considers the implication for PMI premiums in light of the CC's evidence on the magnitude of the reasonable mark-up.

## 4.1. Leakage via non-insurer control of claims

We first consider leakage in situations in which non-insurers gain control of NAF claims. Control of these claims permits non-insurers to generate and retain the reasonable mark-up permitted by law.

Again, we consider the marginal cost to an insurer of underwriting a consumer with probability $p$ of being AF and $(1\text{-}p)$ of being NAF, each NAF claim being rectified at an actual cost $A$ and subrogated at a reasonable cost, $R$.

When NAF claims are controlled by non-insurers, the NAF insurer will recognise that the expected cost of its customer being involved in an AF claim will be the reasonable cost of that claim, but that the expected cost of the customer being involved in a NAF claim is zero, as that claim will be controlled (and any associated margin earned) by another entity. This gives the following marginal cost of underwriting a policy:

$$\boldsymbol{c}^{non-insurer\ NAF\ control} = \boldsymbol{pR} - (\boldsymbol{1} - \boldsymbol{p}) * \boldsymbol{0} = \boldsymbol{pR}$$

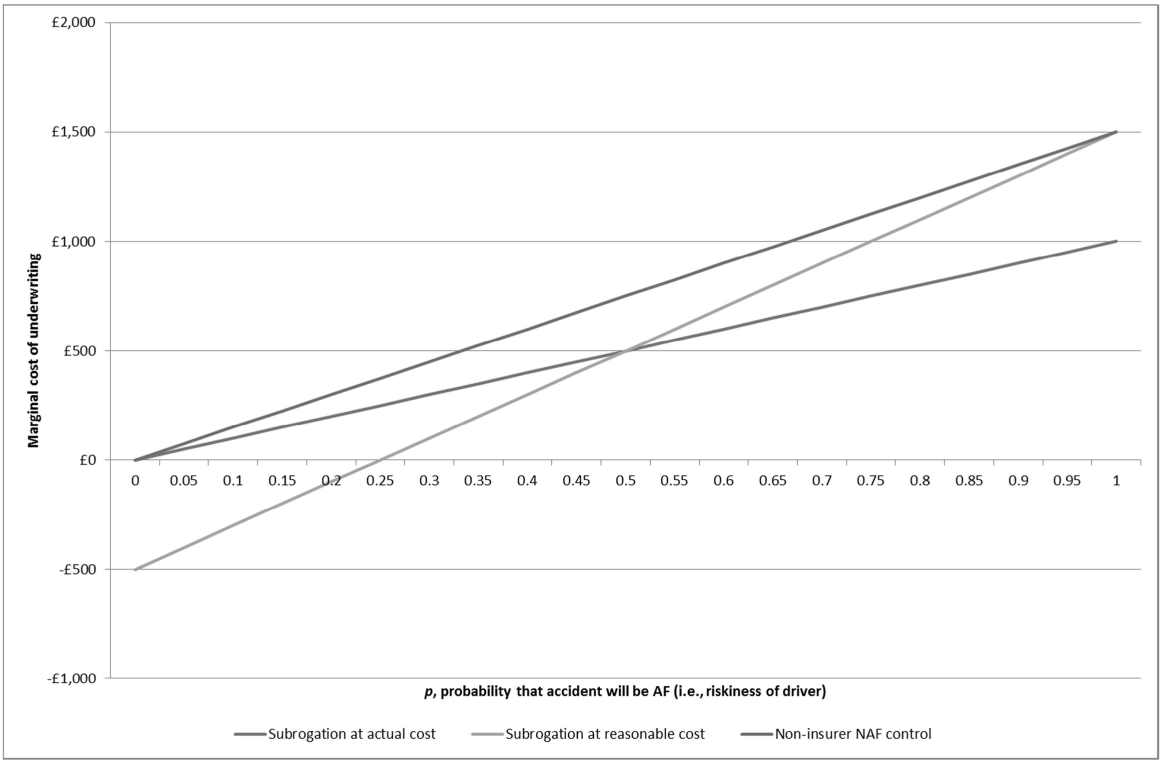
It can be seen that in the event that $p$=0.5 the marginal cost in this scenario is equal to 0.5$R$. It will be recalled that the marginal cost at $p$=0.5 when NAF claims are controlled by the NAF insurer is 0.5$A$, regardless of whether claims are subrogated at actual or reasonable cost.

[13] See, for example, RSA's Response to the CC's Statement of Issues (January 2013), Section A, paragraph 1.4 *et seq*.

Given that $R > A$, it follows that the marginal cost of underwriting policies for consumers equally likely to be involved in AF and NAF accidents is higher under the scenario in which entities other than the NAF insurer control claims than under the scenario in which NAF insurers control claims, regardless of whether the NAF insurer subrogates at reasonable or actual costs. The difference in overall marginal cost is accounted for by the "leakage" of the reasonable cost mark-up to an entity that is not underwriting PMI premiums and so will not regard the mark-up as a negative marginal cost affecting its pricing decisions.

The following chart plots insurers' marginal underwriting cost in the case of non-insurer control of NAF claims against the equivalent cost when NAF claims are controlled by the NAF insurer and subrogated at either actual or reasonable cost (as per figure 1, above).

**Figure 2: Expected marginal cost of underwriting motor insurance policy under non-insurer control of NAF claims (*A*=1000, *R*=1500)**




*Source: RBB calculations.*

Importantly, this chart shows that for all values of *p* <u>the marginal cost of underwriting a PMI policy is higher when non-insurers control NAF claims than when NAF insurers control those claims</u>. It therefore follows that the prices charged to consumers seeking PMI policies will be higher in the scenario where NAF claims are controlled by non-insurers than in the alternative scenario of claims being controlled by the NAF insurer.

## 4.2. Leakage via non-insurer involvement in claims

As well as controlling claims directly, non-insurers may become involved in the NAF claims process when appointed by NAF insurers to provide rectification services to the NAF claimant on the insurer's behalf. In this situation the NAF insurer effectively outsources the provision of the rectification services to the non-insurer, which bears the cost of providing those services and recovers the reasonable cost of doing so from the AF, in return for which it pays a referral fee to the NAF insurer that controls the claim.

In the context of our illustrative model of NAF claims costs, using *f* to represent the referral fee, insurers' marginal costs in this scenario are as follows.

$$\boldsymbol{c}^{non-insurer\ NAF\ involvement} = \boldsymbol{pR} - (\mathbf{1} - \boldsymbol{p})\boldsymbol{f}$$

This expression shows that when an insurer's customer is AF it bears the reasonable cost, *R*, and that when the insurer's customer is NAF it receives the referral fee, *f*.

The referral fee received by the NAF insurer in this scenario is funded from the reasonable mark-up that the non-insurer is able to generate from the claim. This is equivalent to the term *(R-A)* in the section 2 discussion. In principle, given a competitive market for the supply of outsourced rectification outsourcing to NAF insurers, competition between non-insurers might be expected to drive the value of the referral fee towards *(R-A)*. In this case, the expression above would be equivalent to that for marginal costs under subrogation at reasonable costs presented at section 2.1, above.

As noted in the accompanying annex "Quantification of overcosting of TRV and repair services", however, the evidence in the CC's working papers suggests that referral fees paid on NAF claims do not account for the entirety of the overcharge on TRV and repairs. This implies that non-insurers appointed by insurers to handle NAF claims are able to retain for themselves some portion of the reasonable mark-up permitted by law. To the extent that they are able to do so (i.e., that *f* is less than *(R-A)*), this leakage of mark-up outside the insurance industry will drive a wedge between the benefit to insurers of NAF claims and the cost of AF claims, generating net upward pressure on PMI premiums.

In the following section we use data from the CC's evidence on overcosting in PMI NAF claims to quantify the degree of leakage when non-insurers are involved in the claims process, whether via capturing claims or as outsourced service providers.

## 4.3. Summary and wider implications

In this section we use evidence on the value of the reasonable mark-up (which the CC refers to as "overcosting") presented in the CC's working papers to quantify the impact of leakage via the two mechanisms discussed above. As explained in the accompanying annex "Quantification of overcosting of TRV and repair services", RSA's own experience and evidence broadly supports the evidence presented by the CC.

We assess leakage by comparing insurers' marginal costs within our illustrative model for the four scenarios described above: subrogation at actual and reasonable costs without non-insurer intervention; subrogation at reasonable cost where non-insurers control claims; and subrogation at reasonable cost where rectification is outsourced to non-insurers for a referral fee.

We make this comparison on the basis of the aggregate marginal cost across a uniform distribution of risks, that is, the integral of the marginal cost expressions given above over values of *p* from 0 to 1. The marginal costs on this basis are given below.

**Table 2: Aggregate marginal cost expressions**

| | |
|---|---|
| **Subrogation at actual cost without non-insurer intervention** | $\frac{A}{2}$ |
| **Subrogation at reasonable cost without non-insurer intervention** | $\frac{A}{2}$ |
| **Subrogation at reasonable cost with non-insurer control** | $\frac{R}{2}$ |
| **Subrogation at reasonable cost with non-insurer outsourcing** | $\frac{(R-f)}{2}$ |

*Sources: RBB calculations.*

As noted in section 2, the aggregate marginal cost without non-insurer intervention is *A/2* irrespective of whether claims are subrogated at actual or reasonable cost. Consequently, the leakage under the two forms of non-insurer intervention can be quantified as follows.

**Table 3: Expressions for leakage**

| | |
|---|---|
| **Leakage due to non-insurer control** | $\frac{(R-A)}{2}$ |
| **Leakage due to non-insurer outsourcing** | $\frac{(R-f-A)}{2}$ |

*Sources: RBB calculations.*

To quantify these expressions for repairs and TRVs we employ the following figures from the CC's working papers.

**Table 4: Average actual costs, reasonable costs and referral fees on NAF claims**

| | TRV | CMC repair |
|---|---|---|
| **R** | £ 1241 | £ 1576 |
| **A** | £ 618 | £ 1,242 |
| **f** | £ 282 | £ 65 |

*Sources: Working Paper 3 – "Theory of harm 1: Overcosting and overprovision of TRVs", Table 5 (R and A) and Table 10 (f obtained as the midpoint of the range of estimated average referral fees) and Working Paper 2 – "Theory of harm 1: Overcosting and overprovision of repairs", Table 1 (A obtained as the midpoint of the range of the estimated total costs of repair given in row c).*

Applying these figures gives the following estimates of leakage.

**Table 5: Value of leakage per claim**

| | TRV | CMC repair |
|---|---|---|
| **Leakage due to non-insurer control** | £ 311.50 | £ 167.25 |
| **Leakage due to non-insurer outsourcing** | £ 170.75 | £ 134.75 |

*Sources: RBB calculations.*

These figures show that the greatest scope for leakage arises in respect of TRVs, due to the greater reasonable mark-up (c.£600) than is observed for repairs. Where NAF claims are controlled by non-insurers, TRV provision potentially gives rise to £312 leakage per claim. The potential leakage on CMC repairs is £167 per claim.

Where non-insurers are involved in claims via outsourcing arrangements, the potential leakage on TRVs is £171 per claim, and £135 per claim on CMC repairs; while TRV exhibit a greater reasonable mark-up, repairs are characterised by relatively small referral fees and therefore the difference in leakage is smaller than in the case of non-insurer control.

The following table applies the above estimates of leakage on credit hire and credit repair to the CC's evidence on the size of these two markets to estimate the aggregate level of leakage within the PMI industry.

**Table 6: Aggregate value of leakage**

| | Credit hire | Credit repair |
|---|---|---|
| **Annual value of market** | £ 663 million | £ 200 million |
| **Average value per claim** | £ 1241 | £ 1576 |
| **Implied number of claims** | 535,000 | 125,000 |
| **Leakage per claim (lower bound)** | £ 170.75 | £ 134.75 |
| **Overall leakage (lower bound)** | £91.2 million | £17.1 million |
| **Leakage per claim (upper bound)** | £ 311.50 | £167.25 |
| **Overall leakage (upper bound)** | £166.4 million | £21.2 million |

*Sources: Working Paper 3 – "Theory of harm 1: Overcosting and overprovision of TRVs", paragraph 101; Working Paper 2 – "Theory of harm 1: Overcosting and overprovision of repairs", paragraph 8; RBB calculations, implied number of claims rounded to nearest 5,000.*

These estimates imply that leakage across the UK PMI industry due to the involvement of non-insurers amounts to between £105 million and £190 million per annum. Given that leakage places upward pressure on PMI premiums, it follows that leakage raises aggregate premiums by a similar amount.

ANNEX 2 NOT PUBLISHED AS CONFIDENTIAL