DOI: 10.17626/dBEM.ICoM.P00.2015.p015

UPS AND DOWNS: HOW THE FIVE COMPETITIVE FORCES OF PORTER SHAPE STRATEGIES IN THE HUNGARIAN MTPL-MARKET

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Summary: The authors argue that the five forces framework for industry analysis developed by Michael Porter provide a useful strategic management tool for analysing the current developments of the Hungarian MTPL-market. Moreover, the comprehensive analysis of the market forces provides such an insight into the market mechanisms that helps developing successful strategies for the market players of the MTPL-industry. In this first part of the paper, the authors provide an overall description of the methodology, the analysed market and describe its main characteristics using the five forces model of Porter. The analysis provides both theoretical and data-based overview of the five forces: rivalry among existing competitors, threat of new entrants, threat of substitute services and the bargaining power of buyers and suppliers. The results give a plausible explanation for the recent developments of the Hungarian MTPL-market which has been characterized by extreme price competition between (currently) 15 market players and definitely unusual intense rivalry – close to that of the microeconomic perfect competition. We will also analyse the changes in the forces that could shape the future of the industry: due to new regulatory environment, the structure of the MTPL-industry is expected to change significantly thus providing a case for supporting the argument that the five forces are not static, and a dynamic view of the Porter-model for this market can help to develop successful strategies and/or avoid strategic pitfalls.

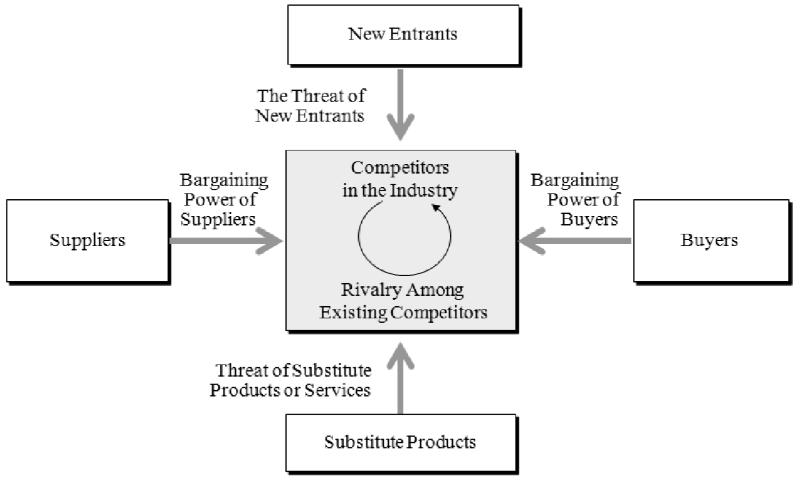
Keywords: strategy, Porter, insurance, MTPL

1. Introduction – the theoretical framework

Michael E. Porter burst into the field of strategic management in the 1980s and currently he is among the most influential and best known management gurus. He is recognized as the most important representative of Mintzberg's positioning strategy schools. He has developed various models, definitions and concepts (e.g. value chain, generic strategies, the diamond model of national competitive advantage, however, without doubt, his best known model is the five forces framework for industry analysis). Porter graduated as an aerospace and mechanical engineer from Princeton University and then completed his PhD at the joint business economics/economics program of Harvard University. The knowledge of IO (Industrial Organization) he has gained during his studies play a key role in turning Porter's attention to the industry structure analysis, an unknown field of strategic management at the time. As a result, in 1980 the book "Competitive Strategy" was published which is now considered a classic.

Porter has always acknowledged that each and every company is unique (and the unique characteristics of a particular company have substantial impact on its competitive situation within the industry), however, using the experiences and knowledge related to IO, he was certain that such conceptual framework, thinking pattern existed to describe the rivalry within the industry from which general and practical conclusions might be drawn. The model he developed fitted this purpose. Let us see how this model can be applied to the Hungarian compulsory motor third party liability insurance (MTPL) market.

Figure 1: Porter's Industry Analysis Model



Source: Porter (2006), p.30

2. The relevant industry: the Hungarian compulsory motor third party liability insurance market

The first step of Porter's industry analysis model is to determine the relevant industry. All authors dealing with this methodology (even Porter himself) frequently emphasize that this step seems to be easy, but may be the source of several typical errors. The MTPL market is such a well-defined and homogeneous market in case of which the risk of a too broad definition of the microenvironment will certainly not arise. At the same time, the legitimate question, whether it may be worth broadening the limits of the industry analysis (e.g. to the non-life insurance market) may arise, as for example none of the MTPL market players operate solely in this industry. Porter suggests on this issue to make our decision based on the analysis of the 5 forces. We will experience that, although in 2013 only 31% of the written premiums of the 15 market players came from the MTPL-market, the market itself has such special characteristics (different from the other insurance classes), on the basis of which it seems reasonable to apply the industry analysis model to the Hungarian MTPL-market.

The best known type of the liability insurances is the compulsory motor third party liability insurance (MTPL), as all motorists come across this service. MTPL is not voluntary, as it is included in its appellation, this insurance is compulsory in the interest of the community. Thus, this ensures that any and all damages caused by motor vehicles are reimbursed irrespective of the solvency of the tortfeasor, and the innocent party is prevented from suffering any disadvantages. Therefore, it is permitted to use a vehicle on the road solely on condition that the operator (owner) obtains valid motor third party liability insurance.

From 1991 such a system was in effect in the Hungarian market, according to which the insured period applicable to the policy of every client corresponded to the calendar year in each and every case, and all insurance companies were obliged to announce simultaneously (until 1 November) their insurance premiums applicable for the following year, and they were not entitled to modify these premiums for a year. Furthermore, the parties had the opportunity to cancel the insurance policies only in November, and the clients could conclude a new contract solely during November-December. As a result, the so called "year-end MTPL campaign" gained high media attention at the end of each year.

Two significant changes have been made to the regulatory environment during the last 10 years. Act LXII of 2009 on compulsory motor third party liability insurance (Hungarian MTPL Act) came in force on 1 January 2010, according to which the insured period does not correspond to the calendar year, but shall be adjusted to the renewal date of the insurance policy. The tariffs valid on the beginning date of the insured period shall be applicable until the next insurance renewal date. Since 2013 another fundamental change has been made to the regulatory environment, the essence of which is that the insurance companies (under the conditions stipulated) may announce new tariffs and change their prior premiums at any time during the year. This was the last step of accomplishing the liberalization of the MTPL market. However, by these two measures, the dynamics of the competition change fundamentally and the intensity of the former year-end campaign decreases.

3. Substitute products

As indicated above, MTPL is a compulsory and practicably standard product, the content of which is regulated (in detail) by specific legislation. Thus, the market players have no such substitute product which may have a negative impact on the market position of the current market players; the threat of substitute products is insignificant. Most of the companies on the market made attempts to differentiate their product. Typically two categories can be distinguished: various insurance riders are offered to the market (e.g. pothole damage insurance, assistance services, tortfeasor insurance rider, accident insurance, etc.) or important guarantees are offered to the clients as a part of their service (e.g. active claim adjustment service). The attempt of brand differentiation can be linked to the latter (e.g. several companies actively communicate their recognitions, prizes, titles). Due to the lack of substitute products, the actual size of the market depends on the numerosity of the Hungarian vehicle fleet: In 2013 there were 4.1 million MTPL policies on the market. In 1998 there were 2.74 million policies on the market and by 2009 their number increased close to 4 million. After declining during 2010-2011, the market has shown growth again since 2012 (Hungarian National Bank (MNB), (2014b)).

4. Barriers to entry

The most important entrance barrier is to ensure compliance with the capital and legal requirements. According to the applicable laws, the minimum guarantee fund in the MTPL insurance class (this is the 10th class in the Hungarian Insurance Act) is 3.7 million EUR in case of either private limited companies or branch offices of third-country insurance companies[4]. However, by the EU accession this entrance barrier became lower for branch offices which come from the EU (where it is sufficient to ensure the combined compliance in the home country), and there was a market player which took this opportunity (ASTRA S.A. Insurance Branch Office in Hungary).
The entrance barriers are medium-high, and since 2004 the barriers of entry have certainly become lower with regard to the insurance companies of EU member states. The number of the market players increased from 10 to 15 between 2003 and 2013 notwithstanding any voluntary or forced exits. On the basis of the experience gained, the threat of new entrants was a reasonable risk for the players already operating on the market. It is the characteristic of the compulsory motor third party liability insurance that liability to pay damages may arise several years after receipt of the written premium and the amount of damages is unknown for

[4] Section 1 b) of Article 126 of Act LX of 2003 on insurance institutions and the insurance business (Hungarian Insurance Act)

long (e.g. as a result of claims involving bodily injuries). Damage claims may remain unknown / not be reported (e.g. claims are reported late) for a long time, and the claim adjustment procedure itself may take several years. By this reason, specialized literature includes MTPL insurance among the so called “long-tail” insurance classes. In the last 10 years four players exited the market by reason of bankruptcy, portfolio transfer and two voluntary exits. Adequacy of the reserves is highly uncertain and there is also great information asymmetry to the detriment of the potential buyer company. These factors render the market transactions of the MTPL portfolio transfers or the sale of insurance companies with MTPL predominant portfolios significantly more difficult.

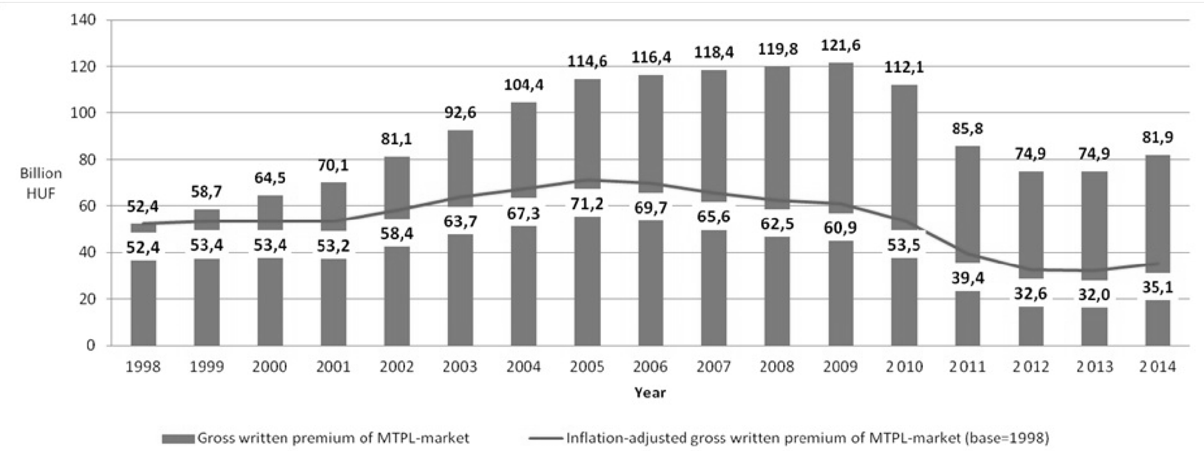
One of the results of the above stated liberalization is that the importance of the campaign period of November-December has notably decreased in two aspects. In parallel to the turnover of the vehicle fleet, less and less motorists have their renewal dates within the campaign period. In 2014 only half of the motorists had the opportunity to change their insurer, the renewal date of the other half of the clients is other than 1 January. According to the other aspect, it was of great strategic importance to the market players to choose the right pricing strategy for the campaign period, because on that single day (when all players simultaneously and blindly laid their cards on the table) the market position of an insurance company, the risk of market loss (and its negative effects) were settled for a year. Therefore, a number of the players tended to choose riskier strategies. Due to the dynamics of the competition, this was the rational choice in many cases (surely in the short term). However, this has changed due the possibility of announcing premiums at any time. Currently the players have the possibility to correct or change their pricing strategy immediately, depending on the competitive situation. This kind of decrease in the importance of the campaign period significantly raises the barrier to entry into the market, as earlier an entry into the market during the campaign period (all entries were performed within this period) promised the entrants the opportunity to quickly capture markets at a lower cost (high media attention, media spending concentrated to this period). A new entrant could acquire several hundred thousand clients within two months by the help of the online insurance brokers (access to this channel demands little time and low costs) and with aggressive pricing.

5. Development of rivalry within the industry

When searching for the answer to the question of how attractive the industry is, the size of the industry is considered to be a key aspect. The MTPL premiums written reached 74.9 billion HUF in 2013. Figure 2 shows how dramatically the written premiums of the market have dropped since 2009: 46.7°billion HUF premium has disappeared from the market and by 2013 the written premiums have fallen by 38 % compared to 2009 with the highest premiums written.

As a result of this, not surprisingly, the dominance of the MTPL market has fallen sharply during the last 15 years. While in 1995 MTPL held a 37% share in the non-life insurance market, in 2013 the size of this share was only 21%. Within the total insurance market the proportion of MTPL has decreased from 22% to 9%. Based solely on these figures, the MTPL market does not seem to be an attractive industry; however, even after the slump of 2010 three of the market players saw the situation differently and made a strategic decision to enter the market. Claim and cost trends have followed the changes of the written premiums. However, costs have decreased to a lesser extent in recent years than the decrease of the premiums. In order to determine the development of claims expenditure, it is a useful piece of information that the claim frequency has dropped significantly on the market (as a consequence of the depression and the introduction of the so-called “zero tolerance” law): while in 2004 the measure of claim frequency was 5.5%, in 2013 it was only 3.2%.

Figure 2: Developments of written premiums of the MTPL market



Source: Hungarian National Bank (MNB) (2014b) and the Hungarian Central Statistical Office (KSH)

One of the most important changes that can be experienced in the MTPL market is the continuous, almost unbroken (with the only exception of 2009) and significant decrease in the degree of market concentration over the last two decades. According to the calculations of N. Kovács, one of the well-established figures of the market concentration, the Herfindahl-Hirschman Index [5]indicated an index value of 3808 points in 1995, while according to my calculation which is based on the market data of 2013, the HHI shows a much lower concentration; its index value is 1232. (Viewed over an even longer period, this decrease in the market concentration has developed from the fully monopolistic situation of 1986 (State Insurance Company, which demerged into two entities in 1987).

6. The bargaining power of buyers

The bargaining power of buyers is strong. The bargaining power and market position of the individual fragmented players in the retail market are insignificant; however, any and all other factors favour the buyers. This is such a standard, homogeneous product, which is on the one hand very difficult to differentiate, on the other hand excessively price-sensitive; besides, brand loyalty is low (loyalty has any significance only within narrow limits). According to customer perception, practicably speaking, the MTPL product is considered to be "vehicle tax", as the significant part of the service (not taking into consideration the elements necessary to maintain the contract in effect, the service as a whole) is used not by the client but the injured party, therefore, it is not surprising that the outmost important aspect of decision making is the price. Due to the strong competition, clients have realized significant savings: from the peak value of the MTPL average premiums (35 120 HUF annual premiums by reference to the total market) of 2007 the average premiums have dropped on the market almost by half, to 19 445 HUF by 2013.

Porter (2001) drew attention to the fact that the advent of the internet might have a major impact on the structure of the industry. The microenvironment has altered significantly on the MTPL market. Due to internet use, online insurance brokers (comparative web portals) have strengthened materially in the past 10 years. Dynamics of the market competition through this

[5]The Herfindahl-Hirschman Index (HHI) is defined as the sum of the squares of the market shares of the companies in the given sector. The index value of 10 000 points indicates a monopolistic market, while the index value of 0 points the fully fragmented pure competition.

sales channel have completely changed. Contrary to the classic sales channels having a dominant position earlier, the clients are able to compare the proposals of the different market players in a couple of minutes, to make a decision quickly (typically one-dimensional, price-based), and to take out a new insurance policy or arrange the transition to another insurer (on the basis of a broker mandate). Therefore, switching costs have significantly decreased (close to zero, to the opportunity costs of the few minutes "work"). Besides, price transparency has materially increased on the market. While earlier it was almost impossible to review the complicated discount schemes, to compare prices, as a result of the internet the market has become fully transparent and the former information asymmetry has ceased. During the campaign period the market players simulated an almost perfect competitive market, (where prices would decrease until MC=MU as per the textbook) which had a negative impact on the prospect of profitability of the sector. The argument above is supported by the trend of the number of clients switching their insurer: the development of online channels and competition trends raised the number of these clients to the peak in 2009; over 1.5 million motorists concluded new contracts. In 2014 this number dropped to approx. 300 000.

7. The bargaining power of suppliers

Related costs of operation and development of IT systems and costs of the claim adjustment procedure (which is outsourced to external service providers by most of the market players) represent significant items among the costs of the MTPL market players. The market of the specific IT services is tight, and in most cases the players have to calculate with significant switching costs if they change their partner (the "lock-in" effect applies), therefore, the bargaining position of the suppliers is moderate/strong in this case. The situation is better in the field of claims adjustment, because most of the market players work in a multi-partner model, so its bargaining position is stronger. Besides, procurement of specific expertise and recruitment of co-workers obtaining adequate knowledge may cause difficulties, some of the fields are subject to the upward pressure on price due to the demanding market.

8. Conclusions

In the last 5 years the microenvironment analysis of the MTPL market shows that the forces which determine the rivalry of the industry have changed in such manner which adversely affects the market players. The two most important changes are the increasing intensity of rivalry and the increasing role of the internet. On the basis of my analysis I have come to the conclusion that the rivalry within the industry is intense, the bargaining position of the buyers is moderate/strong, the bargaining position of the suppliers is moderate, essentially no threat of substitute products exist, the threat of new entrants has been significant recently, however it is likely to become minor in the upcoming years due to the legislative changes.

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