Association of British Insurers

Identifying the Challenges of a CHANGING WORLD

THE TRENDS FACING INSURERS TOWARDS THE 2020s

CHAPTER FIVE

Insurers, Risk Assessment and the Availability of Insurance

Insurance companies exist to serve society by managing its risk, yet the way in which insurers assess risk and the consequences of those judgements are under increasing scrutiny and challenge. For general and protection insurers, the weighting and pricing of risk is at the commercial heart of their business. The science of doing so is core to the industry's professional standing and is an integral component of commercial success, especially in an era of low investment returns.

This section looks at the over-arching trends that are shaping the future and some key issues the industry will need to wrestle with if it is to serve customers effectively while preserving its key operating principles and enhancing its reputation.

For high quality risk assessment to remain at the heart of UK insurance, insurers will need to choose a greater degree of proactivity over defensiveness. Insurers will need to be increasingly open and transparent about how they use risk assessment to deliver products that best meet customer needs and price limits.

The issues facing insurers in this area are formidable but they are not unwinnable battles. With sustained IT investment, greater openness with customers, close relationship with regulators and an ongoing willingness to act collectively to tackle problems, the future offers more opportunity than challenge.

Trends shaping the future are:

i. Risk assessment and pricing increasingly under scrutiny

ii. Increased sensitivity to insurance exclusion

iii. Multi-channel access

iv. Increasing segmentation of customers driven by analytics and renewed focus on underwriting profit

Risk assessment and pricing increasingly under scrutiny

There is no single reason why risk assessment and pricing is under more scrutiny than ever before. In part, it reflects the dynamics of the information-rich and increasingly transparent era we live in; this encourages customers, the media and consumer groups to 'demystify' aspects of financial services they do not understand. The advances of science have also played a part, such as in the development of genetics. Many insurers have responded to this trend, seeking to explain more fully what risk factors they use and how these can impact on the availability and cost of an insurance product. Linked to this **search for information** has been less consent from some customers about risk assessment decisions, empowered by the internet and social media to challenge the specific application of risk factors, their accuracy or relevance to the individual or their overall consequences. This has been most notable in the debates around young drivers, flood insurance and annuity pricing where customers have increasingly expressed strong views about how they feel risk factors should impact on the product and its cost. It has also been reflected in challenges about the use of postcodes and how far insurers should be able to reflect differences within postcode bandings.

Parallel to this has been **increasing challenge** from both UK and EU politicians and stakeholders to the use of risk-pricing. During the passage of the 2010 Equality Act, many UK parliamentarians called for the banning of the use of age risk factors for travel insurance, while the Belgian consumer group, Test Achats, was ultimately successful in 2011 in persuading the European Court of Justice to ban the use of gender in insurance pricing after it had originally been excluded from the EU's Gender Directive. Interestingly, this decision was widely criticised in the UK by consumers as well as politicians with strong support expressed for the principle of insurers being able to recognise the lower accident rate of younger female motorists.

Increasing segmentation of customers driven by analytics and renewed focus on underwriting profit

The huge potential future volumes of data and use of highly sophisticated analytics and predictive underwriting will also be reinforcing and refining insurers' segmentation of their markets, driving a relentless focus on which types of customer a company wishes to serve and designing the product and price accordingly. This is not new; insurers have never wanted to insure every potential customer against every potential risk; taking on too much bad risk can wreck profitability and ultimately solvency. However, as segmentation becomes ever more refined, customers and stakeholders may resent any sense that insurers are picking them rather than the other way round and increasingly argue that insurance is a utility product and should therefore perform accordingly, especially if the product is compulsory like Motor insurance or Employer Liability insurance. Insurers will need to be increasingly up front with their customers about which group they serve and market accordingly, watching other sectors closely, especially the retail sector, to see how they navigate similar terrain.

Key Issues facing Insurers in the future:

As well as responding to these overall trends, insurers face the challenge of some specific industry issues, many of which are familiar, that are thrown into particular relief by the likely dynamics of the future world:

i. How to set renewal pricing that is accepted as fair

ii. How to ensure future products are accessible and fit for purpose

iii. How to balance the use of predictors versus experience in risk assessment

How to set renewal pricing that is accepted as fair

Long-term relationships between businesses and customers are regarded as a positive thing for both parties. However, in certain circumstances, long-term customers of general insurance firms can find themselves disadvantaged by price compared to new customers making the same purchase.

This is not an easy problem to solve. With high numbers of household customers shopping around on price for their annual property insurance, both challenger brands and existing providers looking to re-profile their book of customers will seek to attract new customers by offering initial price discounts. This is normal behaviour in the retail sector and is also apparent in the service sector where an 'introductory' offer will be in place to encourage membership of a gym or golf club where an annual fee is subsequently payable. In the general insurance market, this practice is also fuelled by the presence of the comparator websites with their heavy emphasis on price and by the over-supply of some parts of the market which can lead to too many insurers chasing after too few customers.

The least preferable long-term answer may be a regulatory one, forcing insurers to demonstrate at point of sale the impact of the first year discounted price, so it is clear what the potential impact at renewal will be. A market-driven option would be if an insurer were to seek competitive advantage on the stated basis they did not increase at renewal beyond indexation with the aim of maximising premium income over a five year horizon. An alternative would be complete transparency from insurers to customers that the first year premium included a new customer discount. This could potentially increase churn still further but would limit the chances of the customer being misled about future premium costs. Greater cross-selling may also have a part to play in making the economics of customer retention work, although this would be more complicated when a broker is involved. Without some of these changes or different reforms, it seems hard to see how the current pricing system, however understandable its origins, will survive the challenges of consumers, media, politicians and regulators in the years ahead.

How to ensure future products are accessible and fit for purpose?

The challenges posed by **financial illiteracy** will continue to pose problems of accessibility. As insurers respond to their information hungry customers by delivering more interactive means of assessing policies, the difficulties for those with poor understanding of financial products may grow. The relatively sophisticated judgements involved in buying an insurance or investment product still require a foundation of understanding of concepts such as risk, return compounding and coverage requirements. In order to avoid inaccessibility – or worse, mis-selling – to these customers in future, it may be necessary for insurers themselves to increasingly offer their own online educational tools to help ensure potential customers know what they are buying, in addition to the financial education provided by the State and through bodies such as the Money Advice Service and the Citizens Advice Bureau. This will be particularly necessary because of the failure of the RDR reforms to ensure some form of simplified advice to the mass market.

Many of those with lower levels of financial knowledge will also be those most at risk of struggling with **affordability** of insurance cover, particularly given the likely 'hourglass' shape of UK wealth distribution in the 2020s which could see the lowest 10-20% of the population suffering from considerable economic exclusion, relative to the rest of society. For this group, access to insurance, like all modern day necessities will be a huge challenge on low wages and basic benefits. Given how many people already exist in this bracket, the temptation will be for the market to consider this a permanent, unfixable problem – or at the very least, a

"The digital revolution is changing the balance of power between companies and their customers, making the insurance industry more customer-centric and increasingly reliant on analytics. Harnessing these trends will be an increasingly critical source of competitive advantage."

Paul Geddes, CEO, Direct Line Group

challenge for the politicians running the welfare state to consider. This may be to understate the risks for the industry of this disadvantaged group becoming a lightning rod for political dissatisfaction with insurers who are portrayed – correctly or otherwise – as being uncaring about those unable to afford their product, especially when there are visible concentrations of these people in urban parliamentary constituencies and where high levels of localised crime, fraud or PI claims may create a vicious circle of relatively expensive insurance products for those in society least able to afford them.

Affordability issues are not exclusive to those in the lowest income brackets. However, with levels of disposable income in 2030 predicted to be lower than in 2008[6], insurers will have to build and maintain customer, political and regulatory support for price levels and potentially engage in an almost permanent supply of information to keep customers briefed about how prices are arrived at, the broader risk factors that have contributed and to demonstrate that cost is being managed efficiently to keep prices as low as possible. This is a changed dynamic from now where efficiency metrics are the preserves of analysts, not customers and stakeholders. But if a sizeable chunk of the 'squeezed middle' are finding insurance – or any other consumer necessity – unaffordable in 2030, the digital power at their fingertips via social media will make it very easy for them to focus attention on anything they could argue constituted wasteful or inefficient costs by an insurer which was keeping premiums artificially high, including executive remuneration. Insurers can harness social media as well to have a more open discussion with their customers about the risk factors which lead to unnecessarily high premiums, such as marginal PI claims, fraud and the risks of bad driving. This is more common in commercial lines than in general insurance. The test will be whether affordability issues can be seen as a shared problem between society and insurers rather than something for which the industry is to blame and is expected to fix.

Harnessing **distribution** will also be critical. Without efficient distribution channels, the industry potentially may face a future where it offers good, understandable products at appropriate prices but it lacks the ability to reach potential customers:

- The ability of the **workplace** to offer a trusted environment in which to plan financially and purchase products will offer a major opportunity to make the successful introduction of auto-enrolment the beginning of a major new channel of communication between employee and financial services provider.
- **Brokers** will also have a role, most obviously at the large corporate end but also in helping retail and small commercial customers to bundle together policies effectively and to ensure specialist requirements are catered for in a cost-efficient manner. They too will face challenges over transparency of client relationships and cost.
- **Collective purchasing communities** may also increasingly open up a channel which assists accessibility. This 'collaborative consumption' such as village oil syndicates, the resurgence of interest in credit unions and in online services such as the home-holidaymaker service, AirBnB, could be an essential way for people to group together to minimise the cost of essentials as well as leisure items, with the potential for insurers to use the opportunity of a collective framework to reach customers who would otherwise lack access to the insurance market.

New products will also be important to ensure insurance is meeting the needs of people and business, especially products protecting against reputational damage/data misuse and cyber crime. More subtle will be customers' different requirements of familiar products; **home content insurance will focus increasingly on the value of the data stored in gadgets that are central to the running of the individual's life, rather than on commoditised products like televisions and furniture.** The biggest component of a commercial lines business interruption policy in a decade's time may be the risk of connectivity failure meaning supply chain loss of capacity, rather than physical damage to an office or local infrastructure. In a future where mental health problems are predicted to continue to rise, the most expensive element of an EL or PMI policy may be the cost of mental rehabilitation rather than physical repair following a slip & trip accident. Innovation to meet customer need will have to focus as much on developing existing products as on creating new ones.

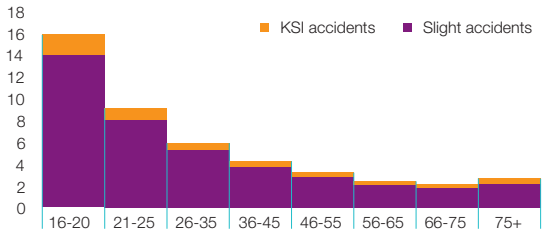
[6] Which? Consumers in 2030 Report

How to balance the use of predictors v experience in risk assessment?

A final – and fundamental – challenge facing insurers over this period will be resolving some of the tensions of how data is actually used to shape risk weighting and the tension between risk assessing on the basis of past evidence and so called 'predictor' factors. In a future likely to be dominated by use of data and analytics, it may be vital to get customer permission for the way in which predictor data, in particular, is used.

The challenge here is the **mismatch between insurer and customer outlooks**. Customers broadly, if wearily, accept that past behaviour affects insurance risk assessment; a penalty notice for speeding will increase motor premiums, as will an at-fault accident. A property premium is likely to go up after an expensive house fire or flood, especially if the causes remain an area of risk. These are also areas where customers are likely to feel a level of control about how they manage their own risks in the future. **Insurers' use of predictor data, however accurate, upsets this dynamic; customers will view their marital status, age and postcode as being facts of life, not proxies for risk** (see Figure 20). They are likely to be particularly unhappy if the postcode on their motor policy is used as a predictor for how likely it is they will be innocently involved in a staged accident where other parties will claim for extensive whiplash injuries. This upsets their notion of fair play and individual responsibility, as well as their belief in the integrity of risk assessment based on proven facts, not educated guesswork.

Figure 20: Accidents per 1000 driving licence holders by age and severity, 2011



Sources: Department for Transport STATS19 Data, DVLA Licence Holder statistics
Notes: Figures show the number of accidents involving a driver in the relevant age band per 1000 driving licence holders in that age band. KSI = Killed or Seriously Injured.

There are no easy answers to this challenge but insurers will gain nothing in the future by avoiding the discussion except the ever more real threats of statutory intervention from MPs representing those most affected. **Insurers will need to be increasingly open and transparent about the predictor factors they use**, the evidence base on which they are founded and any mitigating measures customers can take to dilute their impact. This will mean predictor factors which hitherto have been actuarial curiosities will need to pass more of a public credibility test. The use of postcodes as predictor factors for staged accident risk is partly based on density of claims management companies – this is a fact consumers can understand, even if they resent the impact on them. The more insurers publicise the evidence on which they base their risk assessment, the greater the chance of developing public acceptance which will be a bulwark against political or regulatory interference. Where commoditised systems can be adjusted to offer greater refinement of data, for example sub-post code data, there will also be a neutralising effect.

Most exciting is the extent to which the insurer and insured customer will increasing have a dynamic relationship to assessing risk on the basis of an ongoing supply of data through the extension of telematics to areas such as health and property insurance and annuity assessments. By replacing a static annual data supply with a more engaged process, facilitated by the processing power of modern technology, the customer could feel a greater sense of individual ownership of risk and allow the insurer to rely less on proxies, predictors and other underwriting tools.

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Join the debate

How can insurers tackle the increased sensitivity of those excluded from insurance?

What can general insurers do to establish renewal pricing that is accepted as fair?

How can insurers do more to help those most at risk of not understanding or being able to afford insurance products?

How can insurers strike the best balance in risk assessment between experience and prediction?

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