Institute
and Faculty
of Actuaries

MS14/1: General insurance add-on products

Financial Conduct Authority

Consultation response

8 April 2014

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Barbara Buettner
Financial Conduct Authority
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8 April 2014

Dear Ms Buettner

MS14/1: general insurance add-on products

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to provide comments on the Financial Conduct Authority's (FCA) provisional findings and proposed remedies from its market study of general insurance add-on products. This response has been prepared by IFoA members who work in the general insurance industry.

The IFoA supports the FCA's aim of improving the customer experience by ensuring value, transparency and simplicity. If any 'forced sale' does not meet that aim, the IFoA recognises the need for investigation. Insurance can be complex and that complexity appears in a number of areas where insurance practice varies:

- Policy wordings;
- Interpretation of cover; and
- Approach to claims management (including payment).

Consequently, while many may consider insurance products to be commodities, practice is such that cover is frequently provided on an individual basis. In order to address those differences in practice, it is important that customers are given appropriate information at the point of sale.

General comments

There are benefits of selling one insurance product alongside another for both the insurer and the customer. In particular, the expense of acquisition/purchase is spread across more than one product, leading to a more efficient sale. An example of this can be considered in the cost of selling standalone car breakdown cover, versus offering this cover as an add-on to a consumer purchasing a motor insurance product. Both products have a clear connection so there is logic in purchasing both at the same time. Selling the breakdown cover as an add-on may result in a relatively profitable sale for the insurer arising from the low acquisition costs, but the loss ratios for the add-on can be commensurate with those of standalone car breakdown cover.

The report states *'The Competition Commission found that for private motor insurance, a consumer could be offered up to seven add-ons at once when shopping for motor insurance cover.'* This statement indicates that the provision of stylised cover could be achieved by means of optional add-ons at a single point of sale; therefore the IFoA welcomes the FCA's understanding that defining add-ons is not straightforward.

We also welcome the report's acknowledgement that customers can benefit from the sale of add-ons, due to the profitability of the add-on subsidising the cost of the core product. However, sales incentives should be carefully considered to prevent customer detriment by encouraging add-on sales which are not in the consumer's interest. This highlights the ever-present tension between the demand for, and supply of, insurance and in balancing the interest of the individual consumer alongside the need to have profitable insurers participating in the market..

We have addressed, where appropriate, the specific questions posed by the FCA in relation to each of the four proposed remedies.

1. Impose a deferred opt-in on GAP insurance

Do you agree with the conclusions the FCA have drawn?

The IFoA notes the low "shopping around" of GAP policyholders as the reason for the FCA's focus on GAP insurance. We would welcome a further review of other add-on products, which form a larger part of the insurance market and we explain our reasons for this below.

The FCA states on p50, "*We have not attempted to analyse the extent of any such waterbed effect [the core product is cheaper because the add-on is expensive]. To do so would have involved the analysis of the sale of many primary products along with all the associated add-on products, which was not within the scope of the study*". The IFoA would welcome any further research undertaken by the FCA to understand the waterbed effect, particularly for GAP cover as we would question whether robust conclusions could be made without a strong evidence-base. The IFoA would regard such research as providing an invaluable component to recognise any interaction between the profitability of primary products and add-ons. This would provide further clarity around the fairness of add-on profitability.

Are the proposed remedies likely to become effective?

There is already a post-purchase cooling down period, so the IFoA would question whether this remedy will provide the expected benefit. There may be greater benefit for the consumer in understanding the amount of cover provided by GAP insurance; in particular for longer term policies the cover often offers little value towards the end of the term as the expected payout falls.

GAP insurance can be profitable, but not necessarily for the insurer. Distributors have the ability to add a significant mark up to net prices, which could contribute to the poor value / low claims ratio. We note the FCA's analysis in this area in section 5 of the study.

Imposing a deferred opt-in on GAP insurance introduces the possibility of "unintended consequences" for consumers. We would encourage the FCA to consider all possible impacts on consumers.

2. Ban pre-ticked boxes for add-ons

The IFoA agrees with this approach and would expect it to achieve the aims set out by the FCA.

3. Require firms to publish claims ratios

Do you agree with the conclusions the FCA have drawn?

Claims ratios might be useful to help a consumer understand where the money goes, but claims ratios are a limited measure. Cost of sales, volatility / 'catastrophe' risk, size of premium and the need to cover fixed costs, also require consideration. There seems to be a presumption that a low claims ratio means that someone is making an excessive profit from the sale. This is not always the case. Claims ratios are subject to volatility both in regard to the number of claims and the variable premia on which they are based. A single year ratio may be mis-leading in either direction.

Additionally, some of the analysis could be challenged, possibly strongly challenged, on a statistical basis. Comparing loss ratios for products with significantly different average premiums could encourage inappropriate conclusions. Further analysis in this area would be helpful.

We would recommend that there are better and cheaper ways to achieve this. We have considered these in more detail below.

Are there any reasons why the provisional findings should not become final?

Publishing claims ratios at a detailed product level involves disclosing price sensitive information that could be misleading to consumers if not on a like-for-like basis. Additionally, the FCA's analysis suggests that the problem is often not in the insurers' pricing, but in the distributors' margin, so perhaps the focus of analysis could be broadened. The FCA could usefully examine whether it is possible to get consistent information between direct sales and brokers/intermediaries, otherwise the consequence may be misleading or unfair.

As previously noted, the ever-present tension of treating customers fairly, but recognising the need to manage insurance companies in a prudent manner, must be considered fully. A further discussion on product cross-subsidies would be useful. **Are the proposed remedies likely to become effective?**

Using claims ratio as a core measure of value has limitations and there may be instances where it is misleading; for example, low frequency / high average cost covers. While a very low claims ratio would seem to undermine the value of the add-on for the consumer, this may be overstating things in other cases. Furthermore, concluding that the sole reason for higher profits is the anti-competitive advantage the seller has through the point of sale mechanism of an add-on, is not necessarily the case. For example, as previously expressed, it may be reasonable for a fairly high level of profit to stem from the acquisition cost advantage from this sale. This could translate into both a better profit for the seller, and a more competitive price for the add-on, compared to a stand-alone product that needs to bear the full acquisition cost.

The IFoA would suggest a comparison of the claims ratio with a similar standalone product, rather than comparing in absolute terms, or to other general insurance products. This may provide a more accurate reflection of the impact of the sale. There is tension between what may be beneficial and what may be harmful mainly arising from the sales process.

Are there any other remedies?

The IFoA suggests that a pie chart, showing where the money goes, might be a stronger and possible alternative. This has the added benefit of highlighting where all of the money ends up rather than focusing solely on what is paid out in claims; however, for some products with a catastrophe type exposure the full benefit of the cover may not be immediately obvious.

Showing for example, x% goes to HMRC (IPT), y% to the insurer, z% to the car dealership etc may not be a fair way to compare direct and intermediary sales, but it might be more easily implemented than claims ratios, which may be more misleading. Other industries have shown how this works; food packaging clearly sets out ingredients and nutritional information. For insurance this could include the split for claims, reinsurance, expenses, marketing and commission, with numbers on a standardised basis (e.g. reserves set at the mean level with the numbers averaged over a suitable period).

The IFoA is aware of potential overheads introduced, particularly for distributors, in setting up such a system but believes there is merit in exploring this further.

4. Improve the way add-ons are offered through comparison websites, particularly timing of information on add-ons

Do you agree with the conclusions the FCA have drawn?

The IFoA agrees that improving the way add-ons are offered through comparison websites, particularly the timing of information on add-ons, is appropriate and should help the FCA meet the aims it has set out.

Price comparison websites should be able to promote competition of add-ons sold alongside core insurance products, such as home and motor. If prices and cover of add-ons are explicit alongside the core cover, consumers should be able to take account of these in their purchase decisions and this could be a helpful way of promoting competition.

The IFoA would welcome the opportunity to meet with the FCA before the final findings and remedies are published, to discuss our thoughts in more detail. If the FCA would wish to discuss this response further with the IFoA, please contact Philip Doggart, IFoA Policy Manager (philip.doggart@actuaries.org.uk/ 0131 2401319) in the first instance.

Yours sincerely,

David Hare

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