The Actuarial Profession
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Consultation Response
Office of Fair Trading
Private Motor Insurance Call for Evidence

October 2011

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.

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PRIVATE MOTOR INSURANCE CALL FOR EVIDENCE

Following an informal briefing meeting between members of the Institute and Faculty of Actuaries' General Insurance Practice Executive Committee and OFT officials on 5 October 2011, this note sets out further background information on a number of market issues which we hope members of the team managing the call for evidence might find useful.

Premium rates

In its call for evidence the OFT notes that the AA British Insurance Premium Index indicates that motor insurance rates quoted have increased by 40% in 2010-2011, and asks whether the rates which insurers charge have increased by this amount. Whilst insurers will respond to the specific question, there are some general points which are worth noting in relation to how such indices may differ from the actual amount paid by consumers for motor insurance.

1. Renewals

Indices such as the AA British Insurance Premium Index and the Confused.com/Towers Watson Car Insurance Price Index consider a measure of rates quoted to new business policies. Insurers, knowing more about renewing customers than potential customers, may well chose to influence existing customers to renew by moderating any significant increases they are applying in their underlying rating structures. One major reason for insurers to manage their renewals in such away is to avoid the need to incur acquisition costs to replace renewal business with new business, whose claims experience may be worse and more variable than the business it replaces. There is no publicly available information on the detail of insurers' actions with regard to renewals and any moderations applied.

2. Natural Aging

Customers renewing their policy on the same basis (the same drivers, vehicle, claims, convictions etc) as the previous year are likely to see a decrease in premiums (even if they have full No Claims Discount (NCD)), assuming the insurer has not changed its underlying rating. This is because the customer's profile will age - the customer will be a year older with a further year's driving experience, the car will be a year older and the distance in year's to any claims and convictions increases. The underlying risk, and so the insurance premium which reflects risk, will usually reduce with these aging effects, particularly for young policyholders where the loadings for age reduce significantly as drivers mature and where NCD often increases.

New business indices tend to keep customer profiles exactly the same so that the index explains movements in risk assessment rather than movements relating to a given policy. If a new business premium index indicates that increases are being applied, then this will be on a like for like basis – in reality, and in general, the discount a driver might see from natural aging will moderate the headline index movement.

3. Customer buying behaviour

A customer's ability to shop around, especially with the rise of comparison sites, has increased in recent years. As a result, customers may switch provider to a cheaper rate (or negotiate with their current insurer to match or move towards a competitor's offered premium) much more readily than in the past. In particular, individuals may, in the light of increases in quoted rates, choose to select lesser known brands that previously they had been reluctant to do.

New business indices, which are often based on an average of a certain ranking of quotes, will not reflect this change in customer choice. Put simply, if an index suggests that the 5th cheapest quotation is increasing at a certain rate, this may not reflect the reality of what is being purchased since customers may on average be choosing the 3rd cheapest rate available this year as opposed to on average selecting the 4th cheapest rate available a year ago.

4. New business discounting/offers

In order to attract and convert business, depending on the distribution channel, the actual final premium charged to a customer may be reduced by an insurer or a distributor from the initially suggested new business premium. For example, in the high street broker channel, a discounting facility may be available that will allow a broker, on a more detailed assessment of the customer than a rating structure could accommodate, to discount premium levels. Another example might be those direct insurers who chose to offer discounts from a normal new business rating to try to attract business to them in order to compete against comparison sites. Indices based on standard new business quotations will not reflect this.

5. Insurer/distributor relationship

Insurers might offer different rating according to distribution. For example, an insurer might seek to supply insurance in partnership with a brand retailer. In such cases, the insurer might offer preferential rating for the volume and quality of business associated with the brand.

6. Written vs earned premium

The FSA returns provide information on the change in average earned premium that an insurer has achieved. Earned premium for a particular calendar year represents the proportion of premiums estimated as being at risk in that particular year. Changes in new business quotation indices relate to new business written premium, which is earned during the period of the policy (normally a year) following the policy inception. This, in conjunction with 1-5 above, is also a factor in explaining the difference between new business quoted rates and increases in FSA earned premium figures.

It is also worth noting that published indices indicate that, although at their peak year-on-year quoted new premium rates were increasing at a rate of around 40%, there is evidence that increases in recent months are somewhat lower. For example, the Confused.com/Towers Watson Car Insurance Price Index suggests that at 30 September 2011 the annual rate of price inflation for newly quoted comprehensive cover was 12.3%, down from a peak of nearly 38% at the end of 2010. (See http://www.towerswatson.com/united-kingdom/press).

Third party claims costs

Of Motor claims, Third Party Injury claims (TPI) have seen higher levels of inflation than property damage claims over a long number of years. This has meant that progressively TPI has accounted for an increasing proportion of the cost of claims. Currently TPI accounts for over 50% of the cost of fully comprehensive private motor insurance claims, compared to some 20% 20 years ago. As such, the underlying costs of Motor claims are increasingly driven by the specific experience of the injury perils.

The Institute & Faculty of Actuaries commissioned a working party (the Third Party Working Party or TPWP) to investigate third party motor insurance based on some worrying inflationary trends being reported by individual insurers. This work commenced in 2010 based on 2009 data, and continued in 2011 based on 2010 data. In 2011 TPWP reported its initial findings covering a restricted set of the 2010 data at the Institute and Faculty of Actuaries' General Insurance Pricing Seminar in June 2011. This is being expanded in the work currently being undertaken, with results being published at the 2011 GIRO conference on 12 October.

These findings were based on data collected from 85% of the UK FSA regulated motor market up to and including the year 2010 in addition to data from some non FSA regulated insurers. In addition, the TPWP also carried out research on international trends and the link between the legal framework and claims inflation.

Whilst we recognise that the OFT has excluded the cost of third party bodily injury claims from the primary focus of its work, our evidence suggests that this is the most significant driver of the underlying costs. We would therefore suggest that any view taken on pricing without recognising the drivers of cost risks being limited. As such we feel it may be pertinent for the OFT to consider some of the findings of the TPWP in reaching its conclusions.

The research carried out covers:

a) Contextual research (from wider sources) to help inform the interpretation of the industry data supplied to the TPWP. This is drawn from a variety of sources including data on petrol prices and mileage, data from the NHS Compensation Recovery Unit which receives recoveries from insurance companies in respect of NHS treatment of TPI conditions, data on claims management companies as well as information on the operation of the Ministry of Justice RTA portal which started operation on 30 April 2010.
b) Analysis of the frequency and average costs of TPI and Third Party Property Damage (TPD) claims in successive (accident) years and how these develop over time (given reporting, processing and other delays) before achieving certainty. This analysis addresses issues of claims inflation in aggregate for the whole of the market, but is split by product – comprehensive and non-comprehensive in the case of private motor insurance. The most serious TPI claims were excluded from this data.
c) Analysis of TPI claim frequencies for private car comprehensive policies counting individual claimants as separate claims. (The analysis in b) treats claims involving multiple TPI claimants as single claims)
d) Geographical analysis which sets out regional differences in TPI and TPD claims frequencies and average costs. The geographical analysis divides the country into TV regions. Unfortunately the data quality was not sufficient for Northern Ireland to be included. This data is based on the latest snapshot in time and does not track development over time. As such any data relating to accidents occurring in 2010 is less developed and therefore understated relative to earlier accident years. This data includes data of the very large TPI claims excluded from b).

e) Analysis of large TPI claims considering different claim sizes ranging from those in excess of £100k (indexed at 7% in 2010 money) up to those in excess of £5m. Given the length of time taken for large TPI claims to develop to their ultimate cost, this data was projected using standard actuarial techniques. No projection techniques were used on a), b), c) or d).

The findings of the TPWP are set out a detailed PowerPoint presentation which will be published shortly and which we will forward to you as soon as it becomes available. The working party has also produced two short reports summarising its findings. Both cover elements of a). The first summary report entitled “Third Party Working Party 2011 short report 19.8.11.doc” focuses on findings based on b); whereas the summary report entitled “Motor TPWP – Communications October 2011” (paper 2) focuses on the findings from c), d) and e). We will forward these two papers with the detailed Powerpoint presentation.

Whilst we hope the OFT will find it helpful to review the entirety of our research, we would draw its attention to the following key findings:

1. Insured accident frequencies have been dropping since 2007. However the frequency of TPI claims has been increasing at rates in excess of 5% over a more extended number of years (although a slightly lower rate of increase is recorded between 2009 and 2010). The inflation seen in the proportion of insured accidents involving bodily injury has been higher and is approximately 10% per annum.
2. There are strong regional differences in the proportion of third party accidents involving bodily injury. The North West of England has rates in excess of 40%. Scotland shows the lowest rates, with the north east of Scotland showing rates beneath 15%. The regions with the highest TPI frequencies exhibit slightly lower average TPI costs (indicative of less serious claims) but also have higher TPD costs.
3. These regional differences in TPI claims are correlated with the geographical density of claims management companies. Whilst it is natural to explain the observations in the paragraph above by the presence or otherwise of claims management companies, we should point out that we do not have the data to formally prove any causal link.
4. Large TPI claims, although relatively uncommon, are a significant component of claims costs by virtue of their individual size. Claims in excess of £100k give rise to a cost per policy of around £40. The inflation seen on these large claims has typically been between 5-10% per annum over the period our data covers, with the very largest claims showing significantly higher levels of inflation. There is evidence that for the very largest claims this inflation is accelerating.

Periodical Payment Orders (PPOs) offer annuity-like payments as an alternative to traditional lump sum claim settlements made in respect of very serious bodily injury claims. The PPO Working Party, another Institute and Faculty of Actuaries working party, is also publishing research in October 2011 which shows that just over 30% of claims in excess of £1m are being settled as PPOs rather than lump sums. It should be noted that PPOs introduce additional cost to insurers as care payments are indexed relative to care cost salary inflation. Care salary inflation is such that the cost of these claims to insurers will be materially higher than if the claims were settled as lump sums using the Ogden discount rate of 2.5%.

Reliances and Limitations

As with any analysis, results can be open to misinterpretation. We would therefore encourage the OFT to seek to clarify its interpretation of our work before drawing any conclusions. Whilst noting that best endeavours have been made by the TPWP in carrying out the analysis, it has not been possible to follow the levels of rigour that would normally be followed in formal actuarial work. For example, data has been analysed as provided by companies without any independent verification of that data other than basic checks of reasonableness. No warranty is placed on the research of the TPWP or other working parties as to its content or accuracy by the Institute and Faculty of Actuaries or by any of its members.

Further to this point, not all data considered by the TPWP is of equal quality. Whilst the data in b) and e) has been of high quality, a lower standard of quality was observed in the data from d). A lower standard again was noted for c). Whilst there was no reason to doubt data collected in a) it should be noted that its purpose was contextual and not the principal focus of our research. As such, much less analytical time was spent drawing conclusions from a) than from any other source of data.

Our analysis does not take account of any benefits that might arise from the future banning of referral fees, which might, if packaged with an appropriate set of supporting measures, reduce or constrain future increases in cost. Likewise however it does not take into account the addition costs introduced by version 7 of the Ogden tables published on 10 October 2011 (which allow for improvements in mortality with consequent increases in lifetime care costs), nor the review of the Ogden discount rate which could ultimately increase costs were the discount rate to reduce from its current rate of 2.5%. Whilst the Association of British Insurers has argued for no change to the discount rate, we note that the Association of Personal Injury Lawyers has recommended that the discount rate be set at 1%. Each of these issues introduces a degree of uncertainty into the future development of third party claim costs.

We hope you find this information useful. If you have any questions on this material, please could you contact in the first instance Dawn McIntosh (at dawn.mcintosh@actuaries.org.uk) who will be happy to coordinate our response.

Yours sincerely

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