

The Future of No Claims Bonus

Workshop discussion paper by

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0. Introduction

The purpose of this note is to provide a basis for a workshop discussion. To that end it looks at the practical issues of bonus implementation in the UK and elsewhere, and considers whether developments in technology and industry co-operation will result in the demise of no claims bonus as we know it. A couple of examples of radically different bonus systems have been included to demonstrate alternatives to the UK method, but these are not analysed in detail since more wide ranging papers have covered this ground before. For a similar reason detailed technical analysis has not been included: references at the end of the paper are provided for those who wish to follow this path

1. Present use of bonus

1.1 No claims bonus has become a central platform of the motor insurance market in the UK. A typical form of no claims bonus is shown below:

One year: 25% discount

Two years: 40% discount

Three years: 50% discount

Four years: 60% discount

1.2 Drivers earn an extra year of bonus for each year they remain without “fault” claims up to a maximum of four years, but lose two years bonus for every fault claim which does occur. Fault claims are defined as claims where the cost has not been reclaimed from a third party. Note that this covers claims other than ones where the policyholder has actually been at fault. Theft

claims and accidents where no fault can be determined are included in this definition (this is a common cause of customer complaints). On the other hand, windscreen claims are usually ignored for bonus purposes.

- 1.3 Bonus protection typically costs 15% extra and is usually only available on maximum bonus: bonus stepback normally occurs only in the event of two fault claims in the same year, or three in three years.
- 1.4 The bonus “belongs” to the policyholder and is not transferable from person to person, but can be switched from policy to policy if the policyholder insures more than one car. More importantly, it can be transferred between insurance companies, the vast majority of whom respect each others’ bonus certification. There is no legal requirement for insurers to accept each others’ bonus, but failure to participate in this arrangement would be a major disincentive to new policyholders.
- 1.5 Where there is no history of certification, policyholders should theoretically start from zero bonus, but in practice many companies advance them to one year immediately. Some companies give more favourable deals to policyholders who are taking out a second policy, or others who have a certified track record of claim-free driving on a company car or other vehicle.

1.6 Several variations from this scheme exist in the market:

- a) a common variation is the addition of an extra layer above the four year bonus; a number of companies offer 65% or 70% for five years' bonus, but not necessarily to all their policyholders. An age restriction, e.g. ages 50+, may be used.
- b) loyalty bonus is a less common variation: in this case a non-transferable bonus is built up over several claim-free years. The effect of this is to change the implicit cross-subsidy between new and renewal policyholders. Because of the acquisition costs of new business, the use of similar premium scales for new and renewal business creates an implicit subsidy from renewal to new policyholders as acquisition costs are effectively written off over several years. The use of loyalty bonus which is not available to new policyholders changes this balance between renewal and new business pricing, and so alters retention and acquisition rates. Given the low elasticity of renewal business compared to new business, this strategy is unusual.
- c) no-fault bonus is a technique which has been tried in the past: in this case, bonus is only lost for a claim involving an accident known to be the fault of the insured driver. In other words, thefts or "hit while parked" accidents do not involve loss of bonus. This has one big advantage in that it is popular with the policyholders, but also a very big disadvantage in that it encourages drivers to mis-report accidents as damage incurred while parked, and there is no incentive to minimise theft risk.

2. Bonus in other countries

There is considerable variation in bonus schemes in other countries, particularly in Europe where bonus schemes are often more elaborate than ours and are relied on to provide some differentiation where insurance tariffs are heavily controlled and segmentation restricted.

The ASTIN papers mentioned in the references at the end of the paper provide (a) a detailed description of a wide range of bonus systems from around the world, (b) a rigorous technical analysis of the use of high excesses instead of bonus.

In this paper, two examples (not specifically related to those listed in the ASTIN papers) are described in detail. These have been chosen to demonstrate differences in the scope of bonus schemes elsewhere, and also to illustrate different ways of looking at bonus protection and excess.

- 2.1 The first example is that of a typical European bonus system. The following table lists a bonus system used by many insurers across Western Europe (it does not relate to any specific scheme).

Bonus step	Discount	Years lost on claim (type 1)	Years lost on claim (type 2)
1	-15%	0	0
2	5%	1	0
3	15%	2	0
4	25%	3	0
5	32.5%	4	0
6	42.5%	4	0
7	47.5%	4	0
8	52.5%	4	0
9	57.5%	4	0
10	62.5%	4	0
11	67.5%	5	0
12	72.5%	5	0
13	75%	5	0
14	75%	5	1
15	75%	5	2
16	75%	5	3
17	75%	5	4
18	75%	5	4
19	75%	5	4
20	75%	5	4

All claims are type 1 except for theft, fire or glass claims which follow the type 2 scale. Allowed claims which do not affect bonus include claims where the full cost is recovered, theft claims with an approved security system, and glass claims where a repair was made by an approved repairer.

There is no explicit protection system, but an element of protection is implicit in the bonus scale. A claim on one of the higher steps of bonus will produce a stepback, but only to a step with the same level of discount. Another claim would produce a further stepback, this time to a point where the level of discount is reduced.

The distinctive features of this system as compared to the UK are:

- a) A much longer scale and higher levels of bonus - possibly intended to incorporate an element of age rating.
- b) Built in protection only available to the best risks.
- c) If claim frequencies were similar to the UK market, only a minority of policies would attain the higher levels. In practice, frequencies are lower, and as is the case with the UK, the majority of older drivers inhabit the high discount levels.
- d) Allowed/Disallowed claim definitions are broadly similar to the UK market, although the concept of theft carrying a smaller penalty is different.

2.2 The second example is an innovative system using variable excess rather than premium. As in the previous table, the figures shown here are approximate average values and do not relate to any specific scheme. This scheme is different from the one proposed and analysed in the ASTIN papers, in that it mixes elements of both a conventional bonus system and a high excess system.

Bonus step	Discount (system 1)	Years lost on claim (system 1)	Discount (system 2)	Excess (system 2) *
0	-60%	0	-80%	1500
1	-30%	1	-40%	1500
2	-15%	2	-20%	1500
3 (start)	0%	3	0%	1250
4	15%	3	20%	1220
5	25%	3	35%	1180
6	35%	3	45%	1120
7	45%	3	50%	1000
8	52.5%	3	53%	900
9	60%	3	56%	750
10	65%	3	59%	600
11	70%	3	62%	500
12	75%	3	65%	350

* sterling equivalent

The first system is a conventional discount system with loss of discount on claim. The second system also has a variable discount scale, which can increase with claim-free experience. However, there is no stepback of the discount on claim, only a stepback of the excess.

This system is also combined with a range of several bonus protection schemes which depend on geographical zone and the perils protected.

Some companies are experimenting with this system, in slightly different forms: as yet there has not been sufficient experience to judge the success of the variations on this theme.

3. The future of bonus in the UK

- 3.1 It is apparent from the comparison with other countries that the distinguishing feature of the UK market is that the bonus scale is relatively short. Maximum bonus is achieved in only a few years and the majority of mature drivers in the standard market (around 80%) have maximum bonus. Rather than penalising those with bad experience (unusually bad experience would be required to lose all bonus), it tends to hit those who, for one reason or another, do not possess the required track record of bonus experience. The drivers falling into this category include young drivers, which is not a problem provided that the age rating structure allows for this, but also ex-company car drivers and divorced women. Fleet ownership is high in the UK compared to other countries and the gap in bonus history which occurs as the result of being assigned a company car can penalise a driver with a continuous claim-free history. Family break-up is also an increasing problem. Despite social changes, it still seems to be the case that family cars are usually owned and insured by the husband, and in the future a divorce settlement might also include the consideration of who gets the no claims bonus!

- 3.2 There is a good deal of time and effort expended on the part of insurers in obtaining documentary proof of bonus earned. There have been experiments to see if the saving in time from not checking the assertion of the proposer is outweighed by the loss of revenue from overclaimed bonus. Unfortunately, these experiments have shown that a sufficient number of proposers, either through ignorance or deliberate deception, claim more bonus than that to which they are entitled, to the extent that it is still financially worthwhile to obtain documentary proof.
- 3.3 The market perception of no claims bonus in the UK has a significant problem. Although the industry has standardised on the definition of “allowed” and “disallowed” claim events such that the definition reflects the cost to the insurer of the claim, this is perceived by the public as a very unfair definition. Many policyholders resent the loss of bonus or protected “lives” which follows an accident in which they do not perceive themselves at fault but in which liability could not be laid at the door of a third party. In particular, they are often very angry at the loss of bonus following a theft incident in which they feel they have been penalised for being the victim of crime.
- 3.4 Nevertheless, bonus still seems to be a powerful marketing tool in the right circumstances. The notion of a personal discount seems popular with the public, as can be seen by the fact that companies have introduced higher levels of bonus. It does not seem to matter that these higher bonuses have undoubtedly been offset with higher base premiums, the appearance of a high bonus figure on the proposal form still appeals to the policyholder. This must also account for the popularity of bonus protection, even if it can be demonstrated that for drivers in low risk categories the cost is

not justified: if the expected claim frequency is below 20%, the extra premium charged for the protection is greater than the expected cost to the policyholder of any loss of bonus in the event of a claim. The ironic message is that (a) the public like large bonus figures, and (b) they are prepared to pay extra to keep them.

- 3.5 Increasingly companies are using more sophisticated rating systems and it is likely that a more effective rating system could be constructed that, rather than use the arbitrary rating system of bonus, used the actual claims history of the drivers concerned and took into account the type of event, the cost to the insurer of the event and possibly the circumstances of the loss. The main objection to using such a system in the past has been that, for new proposers, the insurer would have no alternative but to take the proposer's word for his claim history. As has been determined from bonus history experimentation, proposers are not sufficiently accurate in these declarations for comfort.
- 3.6 There is a possibility that this could change in the future. The Claims and Underwriting Exchange (CUE) programme has been set up to record the details of all insurance claims. The aim of this system is for participating insurers to enter the details of all claims made into the system so that other participants can check the claims history of a policyholder. The immediate aim of this system is to prevent deliberate fraud where previous claims have been concealed from an insurer, but it also means that, in principle, any participating insurer now has a means of directly checking the claims history of a proposer rather than relying on declared history or bonus proof.

- 3.7 In practice, this ideal will not be realised immediately, for two reasons. The initial reason is cost: with present technology it would cost too much and take too long to query CUE during the quotation process. However, one might hope that within a few years time, sufficient technological progress will have occurred to make this a feasible proposition. The other obstacle is identification: at present the system relies on the identification of policyholder and drivers by means of name and address. This is by no means infallible and in particular would make it difficult to identify a driver who had made claims on a policy on which he was not the proposer, and not resident at the proposer's address. A possible solution to this would be to identify drivers by their licence number in future. This is a unique, verifiable and permanent identification characteristic of any motorist registered with the DVLA.
- 3.8 In time, such a system of rating based on actual driver experience certified by a central registry might replace bonus in the public's imagination as a much fairer system. If it was made clear that the system (a) took actual experience into account irrespective of the ownership of the car, (b) could not be easily misled by false declarations, and (c) was not likely to penalise drivers unduly as a result of isolated incidents, then this might go a long way to allay the public's concern about what is presently perceived as an arbitrary rating system.

4.0 References

ASTIN Bulletin 1994:

Jon Holtan

University of Oslo and Samvirke Insurance Company Ltd.

“Bonus made easy”

Jean Lemaire and Hongmin Zi

Wharton School, University of Pennsylvania

“High deductibles instead of Bonus-Malus: can it work?”

Jean Lemaire and Hongmin Zi

Wharton School, University of Pennsylvania

“A comparative analysis of 30 Bonus-Malus systems”