Institute and Faculty of Actuaries

15 November 2019

# MS18/1.2 General insurance pricing practices

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

**Key points**

We welcome the FCA's Interim Report in general insurance pricing practices. It is important that the home and motor insurance markets work well and deliver good outcomes for consumers, particularly for those who are vulnerable.

We recognise the importance of insurers having robust product governance: it is crucial that insurers are aware of how their teams and models determine prices, and whether they consider potential harms to customers, particularly to those who may be vulnerable.

We do have a concern that the FCA's report may have an undue focus on the final price consumers have to pay, to the exclusion of almost all other concerns. A big picture view of the insurance product is needed, including an assessment of the overall quality of the product and any associated product add-ons.

It should also be borne in mind that not all of the FCA's proposed interventions would necessarily be good news for all customers. In particular, there could be a 'waterbed effect' where, if the premium for a substantial section of the market reduced significantly, then premiums for the rest of the market might then need to increase. An unintended consequence of this is that some of those who receive the increases might be the 'shop-around but vulnerable' consumer, who may currently not be suffering harm.

The Insurance Distribution Directive came into force just over a year ago. As the FCA notes, it is relevant to the FCA's report. Given the Directive's fairly recent implementation, there may be merit in taking stock on what it is achieving and understanding where gaps may lie, before adding further interventions.


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1. Interim Report on general insurance pricing practices. In developing our response to this report, we have drawn upon our comments made in recent related consultation and discussion papers on fair pricing, insurance value metrics and the fair treatment of vulnerable customers.

2. It is important to note that, as for any IFoA response, we have considered the issues and remedies proposed from the perspective of the public interest.

3. As we mention below, the IFoA supports the FCA's efforts to help ensure the home and motor insurance markets deliver fair value and treatment for all consumers. We believe there is a role for industry bodies to help promote, and provide their perspective on, the FCA's proposals on pricing practices. Given the IFoA's expertise in insurance and our public interest perspective, we would be happy to play a role in the development of the proposals – noting the suggestions we raise under the questions which follow.

4. We would also be delighted to discuss this response, and otherwise provide insight to the FCA in advance of the current proposals being developed into modified proposals for consultation early next year.

**Stakeholder Feedback Questions**

**Q1. Do you have views on the interim findings set out in this report?**

5. The IFoA welcomes the FCA's Interim Report in general insurance pricing practices. We believe it makes a valuable contribution to the ongoing debate around home/ motor insurance pricing, and the direction it has been taking in recent years. As mentioned in the report, it is important that the home and motor insurance markets work well and deliver good outcomes for consumers. It is also important to recognise that home and motor insurance offers valuable benefits and peace of mind to consumers, including those who are vulnerable.

6. We also welcome the extensive research carried out for the FCA on pricing practices. There is much insight contained in the report, which many stakeholders (including consumer groups) should find useful to help raise awareness of the relevant harms in the home/ motor insurance markets.

7. We believe there is significant overlap between this Market Study on general insurance pricing practices and the ongoing FCA work on the fair treatment of vulnerable customers. It is frequently the most vulnerable of customers who seem to be most adversely affected by some of the practices highlighted in the report (including price walking and certain pricing optimisation methods). The Interim Report is thus also welcome from this perspective.

8. We welcome the continued focus of the FCA on insurers improving governance, control and oversight of pricing practices, and transparency / engagement at policy renewal. On this point, we suggest that if the renewal process is opaque for the consumer, then it is potentially also thus for those charged with the oversight of the renewal process.

9. We agree with the statement given in paragraph 5.65, but would suggest adding the text in bold font: '*It is important that firms have strong governance and controls in place to ensure good outcomes for customers given the increasing use of consumer data* ***and new pricing models*** *in general insurance markets'.*

10. We do have a concern that the overall impression given by the report is that consumers should be concerned about the final price they pay, to the exclusion of almost all other concerns. We acknowledge that the report does refer to the importance of the *quality* of general insurance products (as in paragraph 1.8). However, we are less certain that the rest of the report reinforces the importance of the overall value/ benefits of an insurance product beyond the premium charged. This wider assessment of product quality is particularly relevant for home insurance, which has many variations in covers and excesses.

11. In addition, it is also important to note that the overall insurance product offering - including any add-on benefits - should be within the scope of the FCA's review. If the focus is on the core insurance cover only, then interventions may address price walking there. There is then a risk that it still manifests itself in the associated product add-ons, leading to ongoing consumer detriment persisting.

12. The risk of over concentrating on price is that insurers will continue to 'hollow out' policies, reducing quality both of content and of service, to appear to be offering the most competitive deal. We suggest that the FCA should be encouraging both insurers and consumers to think less of the deal in terms of price, but rather the best quality, value-for-money offering.

13. As considered in recent FCA work on insurance distribution, it is also important to recognise the relevance of the whole distribution chain in the context of insurance pricing practices. Margin may be extracted by different stakeholders in this chain, and not just by the end insurer. Insurance brokers who obtain net rates from insurers currently determine the end price and are able to introduce the renewal pricing issues by way of their commission. Brokers (on home and motor insurance) can manage their commissions with very low levels on new business, to drive later renewal pricing increases which recoup this - much like the insurer renewal pricing issue being considered in the Interim Report. This can be despite a panel of insurers underpinning the broker quotes who are competing against each other on price, with the consumer being re-broked from one to another regularly, whilst the broker manages commission levels it takes on each renewal upwards.

14. On a separate point, we think a clear distinction should be made regarding optimising price changes at a portfolio level, versus optimising prices at an individual level. Profits may not be excessive at portfolio level, but cross-subsidies may mask excessive profits made from particular groups of customers.

15. Whilst we note the focus of the Interim Report is on the regulation of the *conduct* of business there may be aspects of innovation and product design which might have implications for *prudential* regulation. The Report refers to one provider fixing their insurance premium for a three year duration. We would expect that such a guarantee could have an insurance capital implication, and thus potentially impact (increase?) the fixed premium charged.

16. In our experience, one reason some consumers may face difficulties in trying to switch at a suitable price is as a result of their risk profile. This may be due to prior claims, certain risk factors or insurance coverage requirements, particularly in relation to home insurance.

17. The Interim Report refers to price walking and the use of complex pricing practices to raise renewal premiums. We believe it is also possible to make use of price walking without needing complex algorithms or optimisation techniques; adding a 5% per annum premium increase can also be 'effective' in this context..

18. We note with interest the statistics in paragraph 6.10: most people (80%) would expect a reward for shopping around, but also many people (51-53%) thought that you should not be penalised for not

shopping around. We believe the reward (bonus) is well known, but the existence of the penalty (malus) may not be as well known.

**Q2. Do you have views on the potential remedies we propose to focus on? What are the potential benefits, challenges and unintended consequences that may arise from these?**

19. One general point to consider is the degree to which the proposed interventions would be good news for all. That may not be the case, at least for some of the interventions.

20. One thing that some insurers do when they make a pricing model change is to look at the winners and losers to assess the impact of the model change on individual policyholders. For example, making a wholesale change to postcode loadings and discounts can have a zero sum impact on a portfolio as a whole. However, unconstrained this could see some customers having their premiums doubled, and others having them halved.

21. More generally, there could be a 'waterbed effect' where, if the premium for a substantial section of the market reduced significantly, then premiums for the rest of the market might then need to increase. An unintended consequence of this is that some of those who receive the increases might be the 'shop-around but vulnerable' consumer, who may currently *not* be suffering harm.

22. The Interim Report notes that 6 million insurance customers could have saved an aggregate of £1.2 billion in 2018. However, this saving may neglect the possibility of the 'waterbed effect' we refer to above. With some pricing interventions it is plausible that *aggregate* premia in the market could remain similar, but with the margin *redistributed* between customers. Currently, those who do not shop around may be paying higher margin than those who do. Given the correlation between vulnerable and inert customers, that current distribution of margin seems inequitable. The proposed remedies could result in a more equitable treatment across groups of customer, but not necessarily create a reduction in *aggregate* premia paid.

23. It is, however, conceivable that greater transparency could lead to more effective competition and that this in itself will reduce aggregate premiums. At this stage though it is not possible to comment on the extent to which this will happen in practice.

24. As touched on earlier, we believe that it is very important to put the onus on insurers to have the right governance. We think it is crucial that senior stakeholders are aware of how their teams and models determine prices, and whether this is always in the context of recognising the potential harms to (particularly) vulnerable customers. If that governance fails, then that might be the point of intervention for the FCA either to seek remedies by individual firms, or to use some element of price regulation (within the market) as a last resort.

25. The Insurance Distribution Directive (IDD) has been in force for just one year and one month (at the time of writing), and its requirements of firms (including in relation to product governance) might address many of the problems identified in the Interim Report. Given the IDD's fairly recent implementation and any associated 'bedding down', it may be too early to fully take stock on what the IDD is achieving, and where gaps may still lie. There may therefore be a risk of implementing an additional tier of remedies when proper enforcement of the IDD could achieve a lot (or not, as the case may turn out to be).

26. Our comments on the specific remedies below are made in the context of our general points above.

**Remedies to tackle high prices for consumers who do not switch or negotiate better deals**

27. We support in principle the proposal to limit pricing practices that allow firms to charge higher prices to consumers who do not switch. This has potential as it could have the beneficial effect of encouraging insurers to move away from these discounts as a primary marketing tool. However, we are less keen on this approach if it were implemented with a blank ban on price increases at renewal, as this could have unintended consequences: it could restrict an insurer's ability to manage a substantial increase in its risk profile. If there were a material increase to the cost of personal injury claims - for example - then it might be expected that *all* relevant premiums would need to increase. In this type of circumstance, a restriction on the ability to increase premiums would not be appropriate.

28. We are less keen on the proposal to restrict the use of specific rating factors, beyond current restrictions (such as gender). It could be hard to police and also be seen as an unwarranted intrusion into sensitive commercial matters. It would also limit the potential for future innovation, which may be of benefit to policyholders.

29. The suggestion in paragraph 7.16 that the FCA might become very proactive in specifying precisely what factors are used in pricing we believe could result in the FCA becoming a pricing regulator. There is a spectrum of possible approaches in this context. We understand the approach of taking responsibility for reviewing US-style rate submissions has required significant regulatory resource. An alternative approach would be to use a principles-based approach regarding the acceptability of using factors that do not relate to cost of claims/ cost to serve.

30. It should also be said that the actuarial profession in the UK, unlike its US counterpart, has no tradition of providing insurers with large numbers of essentially routine rate filings, with the corresponding resource requirement this would entail. The IFoA would be keen to engage with the FCA to ensure that any actuarial requirements were feasible.

31. We understand that when certain US States imposed very restrictive regulations on motor insurers, including a compulsory 'pool' for otherwise declined risks, the end outcome was that many insurers simply withdrew from those States entirely, and overall prices to consumers rose.

32. We do support in principle the proposal that insurers be required to switch customers automatically to cheaper policies, but provided the alternative deals are indeed 'equivalent'. However, 'equivalent' is sometimes difficult to ascertain unless it is demonstrably true that every benefit and option is as good (or superior) to the current product. It is not possible to infer the most important aspect of a product to any one individual unless you ask them; so at best, assumptions are necessary to determine this. This may then possibly fall foul of the IDD requirement to determine and meet each consumer demand /need. It may also become possible for insurers to 'game' the system by introducing new products with minor differences each time, to carry make this exception argument.

33. A more significant problem for insurers looking at the requirement for equivalence is that older policies often have fewer data points captured about the policyholder than are used to calculate the premium for newer policies. Without this data - and whilst assumptions can be made – it could be difficult to assess what the price for the new product would be.  Policyholders can be encouraged to supply this missing rating information, or external databases used in some cases permission allowing. However, this precludes auto-switching as active policyholder in the process is necessary.

34. We also support the principle of encouraging insurers to switch consumers to a 'better' product within their product range. In this context, 'better' should relate to being better value overall, rather than merely a lower price. As with utility bills, the insurance renewal notice could set out the current renewal product/ price and an alternative new business product/ price from the same provider. If there were any reduction in cover or service this would need proper disclosure to the customer.

*Similar comments in relation to product 'equivalence' also apply to products being deemed to be 'better'.*

35. The suggestion in paragraph 7.18 that insurers should be obliged to engage with customers who repeatedly renew also has potential, but the engagement would need to be designed such that it were not counter-productive. Some customers could be suspicious of such approaches and react negatively.

36. We mention above that we support the principle of strong product governance rules, including review of whether products continue to meet the needs of the relevant target market and individual policyholders. Such product reviews are increasingly important in an era of change driven by technological advancement and changing societal expectations.

**Remedies to tackle practices that discourage switching**

37. We agree with measures to tackle practices that discourage switching. There is clearly a problem with auto-renewal where firms make this difficult for policyholders to switch. However, auto-renewal gives policyholders great peace of mind that they will not accidentally find themselves uninsured. The opt-in versus opt-out of auto-renewal debate therefore needs to balance the risk of becoming uninsured versus the potential for harm through pricing practices.

38. In our view the problem is not auto-renewal but silent-renewal. It may therefore be better to have more transparent communication at renewal, so that the policyholder can decide if they need to take action. However, we also recognise that this approach may not be sufficient for vulnerable consumers.

**Remedies to make firms be clearer and more transparent in their dealings with consumers**

39. There is a risk that making simplistic pricing mandatory for the benefit of those customers with the weakest understanding will not be in the best interests of those customers who do have a good understanding and for whom a more sophisticated approach yields benefits. By the very nature of averages (and the need to maintain overall profitability), reducing high premiums must also result in increases for the lowest. Different customers could benefit from different types of information, and thought could be given to how customers access information differently.

40. In relation to increasing public scrutiny of firms' pricing practices, a degree of caution is required here, to ensure that relevant detail provided was insightful but also meaningful. Publication of highly technical information could be of little use to most consumers. Firms may also resist being asked to reveal details of their pricing models on the grounds of commercial sensitivity.

**Q3. Do you have views on the potential remedies that we propose not to focus on? What are the potential benefits, challenges and unintended consequences that may arise from these?**

41. We agree that the remedies set out in paragraph 7.36 should not be pursued. We share the FCA's concerns over the effectiveness of these proposals.

**Q4. Do you think there are other remedies that we should be considering? If so, what remedies and how do you think they would address the harm we have identified?**

42. There has been much industry reflection (and touched on in the Interim Report) about the generally 'broken' nature of the general insurance personal lines market, in regard to its overdependence on price and the impact of on-line price comparison tools. It is clearly very difficult for individual insurers to break this cycle without seriously damaging their own business model. It is equally challenging for the industry collectively to decide on an agreed course of action due to competition laws. We believe

however that the FCA could help here by acting as a facilitator in industry discussions to address this. It may also be possible for the FCA to consider direct action to help insurers move away from using new business offerings as loss-leaders. Furthermore, we believe it could be helpful for the PRA to play a role as changes to firms' business models to address conduct issues may also have a prudential impact.

43. Reference is often made to the need for insurers to publish loss ratios, primarily where they are very low, so as to indicate excessive profit. Very high first-year loss ratios could potentially be used as an indicator of aggressive marketing techniques which could be seen as being contrary to the public interest; however, they could also be indicative of poor initial underwriting or pricing, so some caution would be necessary here.

44. If the home and motor insurance markets evolve such that policies are not sold via heavy introductory discounts, then the need to recoup first-year losses by heavy renewal increases reduces. This could then encourage more equitable pricing methodologies.

45. The Interim Report reveals that far fewer home policies are bought through price comparison websites than for motor, and that the average policy lifetime is longer for home policies than for motor. This indicates that far fewer home policyholders switch providers regularly, than do for motor. In our experience, home insurance has more variation in coverage and terms and conditions than motor insurance. Nevertheless, we believe this is an area that the FCA should investigate further, to find ways to understand this higher degree of 'stickiness' with home insurance policies. It may be that *some* policyholders are content with this 'stickiness'.

46. A further point is the role of improved education of and for the consumer. The Interim Report notes that many consumers are not aware of how motor or home insurance pricing works. We also note the conclusion that, for those who are less aware of how pricing works, they tend to pay higher insurance premiums. Both conclusions are concerning, particularly when considered together. Note that improved education is distinct from more information. Education may not work for all vulnerable consumers, but vulnerable consumers may have interaction with others who could help them.

47. Concerns over a significant number of insurance policyholders being unaware of how their products are priced would be mitigated to the extent that policyholders could 'trust' their insurer to price the policy fairly. This suggests that education could play a complementary role to the remedies suggested (and further points noted above).

48. Allowing for the suggestions above, and comments on the remedies under Q2 and Q3, we suggest that enforcement of the IDD and the FCA rules set out in paragraph 7.39 of the Interim Report may be sufficient remedy in the short term. As we already mention, there is merit in giving these proposals a chance to bed down, before considering where further intervention were necessary.

**Q5. Are you aware of potential changes or innovations in the home and motor insurance markets that may address the harm we have identified? If so, what are these and how will they address the harm and are there any potential unintended consequences?**

49. We agree that innovation and market/ technological developments have considerable potential to improve outcomes for general insurance customers. When developing interventions in the home and motor markets, some consideration should be given to whether they could stifle innovation. This would be a negative consequence in itself for policyholders as well as insurers, but it could also potentially deter new entrants to the market.

50. As the Interim Report notes, there is a growing trend for on-demand insurance. Whilst this could meet evolving customer needs, we also recognise the potential of an increase in harm if a consumer had a desperate need. There may be parallels here with ‘pay day’ loans, or buying foreign currency on arrival at an international airport.

51. A further development described is auto-switching, enabled by artificial intelligence. As noted, this has the potential to save the consumer the time and effort involved in researching the best policy. However, there are also associated unintended consequences. For example, could an artificial intelligence algorithm manipulate policy excess levels to obtain a lower premium?

52. We do see potential in artificial intelligence being harnessed to produce tailored policy renewal letters which fully explain the reasons for changes in premium.

Should you want to discuss any of the points raised please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk) in the first instance.

Yours Sincerely,

John Taylor
**President, Institute and Faculty of Actuaries**