The magic of averages to the aid of the millions: Protecting the public in the 21st century

Summary

- Good insurance lies at the heart of protecting the public, however some stakeholders are debating whether the sector is working effectively.
- Some are concerned whether the sector is able to respond to a changing society.
- Others debate whether its market practises are effective and fair, or whether they are simply features of the way insurance is designed.
- Meanwhile another debate ensues about the extent to which financial regulation and industry initiatives are dealing with these issues.
- The sector as a whole is on a journey towards better public trust and confidence, and it must be proactive in improving public attitudes.

Introduction: the challenge for insurance

Good insurance lies at the heart of protecting the public. For centuries, insurance has provided an efficient approach to mitigating the worst effects of misfortune. It does this through what Churchill described as "the magic of averages to the aid of the millions": by sharing the costs borne by the claiming few across the risks of the many. In so doing, insurance has made society more resilient to shocks while freeing up government resources to be spent on the few dangers that cannot be insured.

But is the insurance sector living up to this role? Many can cite examples of insurance rising to the call in society's time of need. There are some, however, who are less optimistic, expressing concerns about customers paying over the odds for policies of questionable value. They question whether the sector is up for the complex future challenges, such as climate change, cyber threats and an ageing population. A debate is clearly at hand, extending across three broad fronts:

- changes in the insurance market and society more generally, with mass-market commoditisation and emerging challenges;
- issues about how insurance is developed, priced, marketed and sold to the public, be they retail consumers or businesses; and
- how to respond to these issues, including the role of statutory regulation, industry-led initiatives and professional standards.

This paper examines and confronts this debate. We asked twelve contributors spanning the insurance landscape to describe some of the issues the sector faces in this environment. In so doing we take a fresh look at these areas, and stimulate thinking about solutions that lead to better outcomes for both the insurance profession and the public at large.

> *"We take a fresh look at these issues in general insurance, and stimulate thinking about solutions that lead to better outcomes for both the insurance profession and the public at large."*

Part 1 – A changing society and market

The last several years have seen major challenges confronting the insurance market, only some of which are down to the financial crisis and world economy. The key issues can be summarised across two key themes:

Insurance for the mass market

The need for insurance has reached unprecedented importance in modern times. More affluent consumers possess more products and undertake more activities that need to be insured. For example, take three aspects of everyday life: motor, home ownership, and foreign travel:

- On the roads, there is now slightly more than one car on average for every household in Britain, compared to under half in 1971.[1] There should be no surprise that mandatory motor insurance is now the largest single category of the personal lines market, making up about 37% of all personal lines Gross Written Premium (GWP) in 2010.[2]
- Household insurance has the second largest share at 29% of all personal lines GWP.[3] Although property owner-occupancy in the UK has declined slightly in recent years following the mortgage crisis; this still accounts for about two-thirds of all residential properties, compared to only a third in 1959.[4] Finally
- While foreign travel by UK residents has decreased slightly in recent years, given exchange rates and the recession, 2011 still saw on average just under one foreign visit for every member of the UK population, compared to just under half in 1990.[5]

Aside from these three insurable activities, people are buying more insurance. The value of the industry itself across the various lines has grown: personal lines GWP for motor, property, general liability, accident & health and pecuniary loss have all grown by on average about 2–3% annually from 1990 to 2009.[6]

The advent of mass market insurance has led to fundamental changes in product design and distribution. Products have become commoditised, with standard terms and sophisticated—and sometimes not so sophisticated—risk pricing techniques. Aggregators are challenging direct writers for control of distribution, with 50% of new private motor business generated this way in 2011.[7] Research suggests that consumer brand awareness of aggregators is as high as it is for many insurers.[8]

Several of the contributions in this report allude to these changing market conditions. Most notably, Amanda Blanc of AXA UK gives an insurer's perspective and focuses primarily on trust. She describes some of the challenges to this market and explains that building public trust and confidence is, in her view, the greatest test. Rising to this will help the industry confront other issues such as technological advancements and dealing with public policy themes such as flood risk, reform to personal motor insurance and fraud.

Emerging risks

The sector is seeing an explosion of claims related to extreme weather, cyber-crime and demographics. Two contributions in this paper allude to these emerging and changing risks. On the subject of climate change and flooding, established expert in this field Professor David Crichton looks particularly at the need for change in the planning system to make communities more flood resilient and in the process demonstrates how insurance plays a key role in determining which climate change future the UK faces. He also argues that the Government's need to be similarly forward looking is long overdue, as recent catastrophes in the UK have demonstrated.

1 RAC Foundation, Car Ownership in Great Britain, Oct 2008.
2 Datamonitor, UK Personal General Insurance, 2011.
3 Ibid.; ABI, UK Insurance Key Facts, Sep 2012.
4 FSA, Mortgage Market Review Data Pack, Supplement to PS12/16, Oct 2012.
5 ONS, Travel Trends 2011, 26 July 2012.
6 Datamonitor, UK Personal General Insurance, 2010.
7 Ibid.
8 Research by Ernst & Young for the CII, May 2010.

Also in this report, Sophie Spink from Zurich describes the implications of these changing risks from the perspective of a major global insurer. She describes Zurich's natural catastrophe response strategy and also looks at how it applies Enterprise Risk Management principles in dealing with other risks. Related to this, the direction of public policy suggests that the take-up of general insurance is set to rise even further, as governments struggle with ageing populations and fewer resources. This is happening right now with pensions and long-term care, but is also beginning to happen in general insurance: witness private medical insurance, personal accident insurance and income protection.

Part 2 – Insurance design, marketing and sales practices

General insurance should be a relatively straightforward retail proposition. It should be easy to understand: policyholders pay a premium in return for cover against pre-determined risks. It has many of the hallmarks of a competitive market: most people are served by a healthy range of providers for most lines; and most policies cover a short time period and have to be renewed annually, which should encourage switching. Despite these hallmarks, the fundamental aspects of general insurance can be quite complex. Many of the issues in the sector derive at least in part from this.

The concept of insurance: a promise to pay

For a start, insurance is a promise to pay in the event of a risk occurring. This is quite abstract compared to other retail propositions. Insurance thrives on the simple human desire for peace of mind: but fundamental to this is the element of trust required to believe that the insurer will actually pay a claim. The "magic of averages", as Winston Churchill eloquently described in his 1909 speech, means that very few customers actually make a claim, so really insurance is a payment for a claim that will hopefully never be made.

Not all risks should be insured

Insurance is not the most efficient solution for all risks. For some risks, simply absorbing the cost of the peril might be a better option, as the cost might not be that destructive. So the customer needs to take a view on how likely the risk could occur and the cost of absorbing the peril. This is not a process that comes naturally to people, and consequently the FSA highlighted "products of limited value" as one of the key general insurance risks in its 2012 *Retail Conduct Risk Outlook*.[9] Which? has also made no secret of its concerns about "potentially unnecessary" policies.[10]

Insurance is often a "sell" rather than a "buy"

While some insurance, such as motor and home, is mandatory, most is voluntary requiring the customer to think about possible risks that should be insured. However, most people tend to only think of the risks that come immediately to mind, either by their own experiences or awareness through friends and family or the news. This human trait is known as the *availability bias*, and its implications on general insurance were described in the book *Nudge*.[11] Consumers therefore have to rely on marketing, which on some occasions presents some interesting implications for sales practices.

9 FSA, Retail Conduct Risk Outlook 2012, pp.77-78.
10 "£100m down the drain: raw deal for water company customers," Which? (May 2012), pp.22-23.
11 Richard Thaler and Cass Sunstein, Nudge (London: Yale University Press, 2008), pp.24-26; Financial Conduct Authority, Risk Outlook 2013 (published 25 March 2013), pp.15– 16.

This is precisely what lay at the root of the recent Payment Protection Insurance (PPI) scandal in the UK. In this report, Teresa Perchard, Head of Policy & Advocacy at Citizens Advice, provides an important case study on this episode in recent history. She details how the scandal developed, how consumer groups tried to raise the alarm, and the various stages of response by the regulators. We are not saying the current issues in the wider general insurance are anywhere near the scale of PPI. However, all stakeholders should be mindful of the causes of that scandal, and why consumers had to suffer for so long before the appropriate safeguards were triggered. As far as the public is concerned, PPI was part of the insurance sector. So in the **public's** mind, the sector needs to show that it has learned its lessons and moved on.

Pricing

In theory, insurance premiums seem a straightforward proposition presenting a relatively fixed headline cost for insuring the risk, normally over the life of the policy. This is not always so clear in reality. A fundamental feature of insurance is the principle that risks are priced accordingly, and are often inherently specific to the policyholder.

Risk-pricing can give rise to potentially discriminatory generalisations: age, lifestyle and location can all be risk determinants. The European Court's ban on gender pricing has placed this under scrutiny, and arguably could lead to future rulings on other determinants such as age and disabilities. This not only presents the challenge of creating a form of pricing that balances individuality with equality; it also provides a test-case of the need to respond to the societal challenges described above. In our report, Gordon Morris of Age UK describes the scale of the problem for older consumers, and questions whether the sector is responding adequately to the ageing population. If this is how the sector is handling the ageing population, how will it fare for diversity, cyber-crime and other emerging risks?

Transparency

A related element of pricing and insurance is that the product features underpinning that price are not always the same. This transparency issue has been the focus of the regulator's pre-sale "Key Facts" disclosure material introduced in 2005, an approach predicated on consumers prioritising in advance what features are most important to them. In practice, those consumers who do shop around, do so on the basis of headline price without considering the product features.

Simon Green, Head of General Insurance at the newly formed Financial Conduct Authority (FCA), explains the regulator's new approach of looking more closely at pricing processes, as part of its general approach to product design and distribution. While pricing itself is a competition issue that is still outside the FCA's remit, the Authority can still look at how firms approach pricing with respect to their wider business model. Meanwhile, Adam Phillips of the Financial Services Consumer Panel (FSCP) highlights pricing as being fundamental to consumer protection. He suggests that transparency might be tackled with the creation of baseline specifications for the various personal lines. This would have a set of minimum essential features that must be included, which might help consumers better compare like with like.

Claims may not go as expected

Claims is the landmark moment for insurance customers, where the insurance "promise" is tested. Insurers must assess the legitimacy of the claim and then explore the damages incurred based on market factors. While this is fundamental to insurance, there are issues arising that question the extent to which insurance lives up to its "promise".

One issue is the quality and speed of the claims process and the integrity of outsourcing claims management and loss adjusting. Again, Adam Phillips of the FSCP describes the claims management experience as one of the "biggest areas of dissatisfaction" for consumers. He particularly highlights outsourcing and the implications for customer service, as well as payment and incentive structures.

Another, even more controversial, issue in claims is the charge that some insurers may actually be underwriting risks at claim rather than contract stage. This appears to lie at the root of the concerns expressed by Caroline Mitchell of the Financial Ombudsman Service. Consumers were effectively paying premiums for years, for policies that had not been properly assessed. Only when a claim was made did insurers actually check to see whether the policy was appropriate in the first place. This activity formed the basis of the call to review consumer insurance contract law, in no small part influenced by case law decisions by the Ombudsman.

Part 3 – Solutions: balancing regulation and industry initiatives

Having discussed the issues confronting the sector, we will now turn to the various responses by the regulator and industry.

Regulation

Changing market practices have resulted in major reforms to insurance regulation, on the back of concerns about conflict of interest and selling practices. Insurance selling was fully self-regulated less than a decade ago. Only in 2005 did a multi-layered FSA statutory regime come into force. April 2013 saw this being strengthened still further with the introduction of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA).

Three contributions in this report discuss the changing regulatory landscape. The FCA's Simon Green provides an overview of the regulator's new approach to supervising the insurance industry, looking at such things as senior management, product design, and business models.

Meanwhile, Jonathan Evans MP stands back and looks at the changing structures from his position as Chair of the All-Party Parliamentary Group for Insurance and Financial Services. He asks whether the regulator will be sufficiently ahead of the curve on issues like claims management companies and new technological developments.

Perhaps the FCA's new approach, promising a better culture rather than just regulatory processes, will play a stronger role in changing performance and improving consumer outcomes? It's Business Plan, published at the end of March 2013, went into more detail on the regulator's focus on culture, and shows how the points summarised in Simon Green's paper will look in practice. Whereas previously, firms were regulated through rules and principles, the FCA plans to take a more holistic view of how firms are treating their customers. As PRA Chief Executive Andrew Bailey put it to *The New York Times*, "You can't regulate culture, but we expect standards that put more emphasis on the public interest."

Industry solutions

This new regulatory approach is clearly predicated on a significant degree of buy-in and support from the sector, in order to realise the better culture and public interest outcomes. So now, more than ever, the key to building trust and confidence is striking the right balance between statutory financial regulation and industry-led solutions.

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The insurance industry comes from a good starting place compared to the rest of the financial services sector. Many of the issues described above—the promise, insurability, availability bias, risk-pricing, and distribution issues—all stem from fundamental features of the market which are, in most cases, fairly benign.

As Dr Scott sets out in his foreword, the sector must not rest on its laurels but confront these issues head on. Even if they are a by-product of the overall insurance proposition, they still need to be examined, and improvements need to be considered. Some of those challenges and issues are very real concerns.

The industry is working on initiatives. Huw Evans of the Association of British Insurers describes in his contribution some of the work the industry is doing to respond to the issues summarised above. For example, in motor insurance, the trade association is working to reduce costs through better processes, addressing the massive issue of whiplash claims, and improving road safety through initiatives like graduated licensing for young drivers.

However, industry-wide public policy responses do have their limitations. Insurance trade press journalist Jonathan Swift takes a spectator's look at how the sector has responded to issues in motor insurance over the last few years. His prognosis is that despite some collaborative actions in recent years, more could be done, and that there is only so much that industry-wide public policy activity can do. The rest has to be down to firms themselves, and the people who work for them.

Professionalism: The role of the people in the industry

For many of those issues, it is down to the practitioners of the industry to exercise professional judgement at all levels in the insurance process: from underwriters who price the products, brokers who sell them, and claims staff that assess whether or how a payout should be made. Amanda Blanc's essay describes how firms that demonstrate professionalism at a corporate level require the adoption of professional standards, not just by individual staff, but as a culture within the firm:

- Executive management: staff must have the necessary experience and expertise to ensure that the business model is sustainable and to implement the model effectively;
- Corporate systems and controls, including corporate governance: these should exert appropriate levels of control over the running of the business including risk management, maintaining adequate capital, record keeping, training and competency programmes, and developing a culture that encourages the fair treatment of customers; and
- Employee professional support: encouragement of professional standards for employees through supporting technical training and development and encouraging appropriate behaviour.

Amanda Blanc describes how initiatives such as the insurance sector's Aldermanbury Declaration aim to entrench these principles across firms. As AXA Commercial and Intermediated Personal Lines CEO, she comes from a unique position of understanding how relevant these issues are to retail as well as commercial insurance markets. She was also a founding member of the task force of sector leaders that put together the Aldermanbury Declaration, and explains that promoting professional excellence and high ethical standards will have a strong and positive effect on improving public confidence across insurance. There should be no reason why initiatives that are making significant progress among firms in the commercial insurance sector should not also extend to the retail markets.

Nearly 180 general insurance firms, including some major brands, have adopted the CII's Corporate Chartered status that codifies these three principles in a more formal professional body commitment. Duncan Minty explains in this paper why this take-up of Chartered status is an important milestone. He argues that firms should incorporate ethical key performance indicators into remuneration structures and regulators should monitor these. This way, firms that "do the right thing" would be incentivised by the regulator in the form of less onerous regulatory oversight. Professional standards can play an important role in improving the quality and perception of the insurance market. It is also complementary to the new regulatory focus on industry culture and standards described above.

How does this translate into practice?

So how do these professionalism principles actually work to make a difference to customers? This is the ultimate question for any professional body, and one where ready-made and easy-to-observe causal relationships are not available. Consumers know in their minds that better qualified professionals do give better service, and surveys indicate that they trust Chartered practitioners more than others.

Returning to the issues described as an example, insurability and pricing transparency are about treating customers fairly and ethically. Telematics in motor and life insurance shows the beginnings of a move towards pricing insurance on the basis of *usage* by the specific customer presently, rather than on features of allegedly similar users in the past. It is an example of people at various levels of the industry applying professional knowledge and considering ethical principles, from those designing better underwriting methods to realise fairer pricing to those selling the products to ensure it is used in the most appropriate situations.

Aside from these general trends that suggest improvement, the link between higher professional standards and better customer outcomes needs to be better understood. We are undertaking an extensive project assessing customer attitudes through consumer and small business surveys, and designing a set of indices to analyse this data. Over time, this will provide the sector with a valuable tool to measure progress, starting with a "baseline" paper which we intend to publish later this year.

Conclusion: a journey to better public trust and confidence

The general insurance profession, and the sector as a whole, is on a journey towards better public trust and confidence. We have seen in this essay how public attitudes towards insurance are changing, and their expectations are rising. Regulatory changes point to the need for a new mindset in conduct and culture by both individuals and firms, and industry initiatives need to make this happen. In an insurance market in a changing world, it will be down to the people in the sector acting professionally to confront the issues and challenges.

The sector faces a choice. It can take a reactive approach to the issues it faces, or it can respond with vigour and enthusiasm towards finding solutions. The insurance profession has demonstrated—through initiatives like the Aldermanbury Declaration and Chartered status—that it can lead and make the changes required both for improving the sector and the public interest.