



FINANCIAL  
SERVICES  
FACULTY

# Audit insights: insurance



## About The ICAEW Financial Services Faculty

The ICAEW Financial Services Faculty was launched at the start of 2007 to provide professional support to ICAEW's members working across the financial services sector, to influence public debates on regulation and standards affecting the sector and to become a world-class centre for thought leadership. The *Inspiring Confidence in Financial Services* initiative was established in early 2007. It aims to provoke new thinking and identify better ways of tackling long-term challenges in the financial services sector.

Confidence is vital to financial services. A stable financial system is important to the economy and sustainable levels of confidence in financial services are needed for this stability. Our work is based upon four themes, which are interdependent and cannot be considered in isolation.

These themes are:

- responsible providers;
- responsible consumers;
- better information; and
- better regulation.

Our work involves developing reports and provocative issues papers, holding high-profile conferences and having discussions with stakeholders. We aim to bring together the financial services sector, industry professionals, consumers, regulators and policymakers. We believe that financial services will only inspire confidence if the sector engages with all of its stakeholders.

For more information about the *Inspiring Confidence in Financial Services* initiative, visit [icaew.com/inspiringconfidence](http://icaew.com/inspiringconfidence). For more information about the Financial Services Faculty visit [icaew.com/fsf](http://icaew.com/fsf). Alternatively contact Iain Coke at [iain.coke@icaew.com](mailto:iain.coke@icaew.com)

## About the ICAEW Audit and Assurance Faculty

The ICAEW Audit and Assurance Faculty is a leading authority on external audit and other assurance services. It is recognised internationally by members, professional bodies and others as a source of expertise on issues related to audit and assurance. *Audit Insights* is one of several initiatives launched by the faculty.

*AuditFutures* is a thought leadership initiative of ICAEW's Audit and Assurance Faculty, established in 2012 in partnership with the Finance Innovation Lab. As a catalyst for new thinking and fresh perspectives, it aims to inspire collaborative innovation and constructive dialogue about the evolving role of audit and the accountancy profession in modern society.

Through the *re:Assurance* initiative, the faculty is finding out where assurance services over business information, such as key performance indicators, could strengthen markets and enhance confidence and also asking how the International Framework for Assurance Engagements can be applied and developed. The faculty answers demands for practical guidance with publications such as *The Assurance Sourcebook*.

The faculty's Audit Quality Forum (AQF) brings together external auditors, investors, business and regulatory bodies, encouraging stakeholders to work together by promoting open and constructive dialogue about transparency, accountability, reporting and confidence in external audit.

For more information on the Audit and Assurance Faculty, the current work programmes and how to get involved, please visit [icaew.com/audit](http://icaew.com/audit). To learn more about *Audit Insights* please contact Henry Irving at [henry.irving@icaew.com](mailto:henry.irving@icaew.com), or on +44 (0)20 7920 8450.

# Executive summary



## Flag 1: What should society do for uninsurables?

The effectiveness of insurance depends on individuals having similar risk exposure, and being willing to share those risks with others. As data and technology enable greater exploitation of the differences between us, some individuals may be priced out of insurance cover. Society must make the choice about when to intervene to ensure that those who are vulnerable are able to access insurance cover.



## Flag 3: Taking out the insurance middle man saves costs, but at what price?

Technology has allowed insurance companies to get closer to their customers. Customers benefit from reduced costs and greater access to information. However, the complexity of insurance products means that not all customers may be capable or empowered to make good choices without advice.



## Flag 2: Do insurers still have the best data?

Insurers must know their customers in order to create and charge the right price for products. Other businesses now have better information about these customers. To remain competitive, insurers need to work to ensure that they remain best placed to understand the risks that their customers are exposed to.



## Flag 4: How does the new normal change insurance business models?

Insurance premiums alone don't lead to profits. In a challenging economic environment the business model of insurance, which requires investment returns in order to pay claims and generate a profit for shareholders, must adapt.

# Insurance – a social necessity

While creating certainty for others, the insurance industry faces a very uncertain time itself. Insurance did not contribute to the financial crisis in the same way as banking, but its aftermath has led to regulatory and economic effects that are having a major influence on the sector.

Rapid economic, social, political and environmental changes occurring across the globe are leading to significant changes in the risks that the insurance industry provides protection against. The industry must evolve to remain viable in the future. The outcome of risks cannot be fully known, but the identification, measurement and management of these various risks is essential to the success of insurers.

Our report is set against the context of changes in society, the economy and technology. It seeks to provide insight into how this complex industry will meet these changes, continue to thrive, and maintain its social purpose. We want to undermine the myth that it is too difficult to have a meaningful conversation about insurance.

*Audit insights: insurance* is based on the collective insights of insurance audit specialists from BDO, Deloitte, EY, Grant Thornton, KPMG, Mazars, PKF Littlejohn and PwC.

## Why do we need insurance?

Insurance allows individuals and businesses to manage and transfer the risks that they are exposed to, both those encountered regularly in the course of everyday life and those that only arise in exceptional circumstances. Policyholders can reduce uncertainty as their insurer will compensate them for unexpected losses from which they may not be able to recover alone.

In order to fulfil this wider social purpose, insurance companies work on the basis of pooling risk. Pooling financial resources (through the payment of premiums) and the insurer taking on the collective risk allows those 'in the pool' to spread the risks more evenly among themselves.

The nature of insurance products means that, alongside the responsibility to generate a return for their investors, insurers must balance their responsibilities to policyholders, which include:



- the safety of policyholder investments;
- paying claims fairly and on a timely basis; and
- giving confidence that they can deliver on future commitments.

To do this effectively the insurance industry and insurance companies need to be better understood, so that they are trusted and can attract capital and customers. A lack of understanding of the risks in the industry, uncertainty in capital requirements and a lack of transparency and comparability in financial reporting amplify these issues.

## One industry, two businesses

Life insurance involves providing long-term savings products such as pensions or a potential nest egg for dependents in case an income earner suffers an early death. Non-life or general insurance typically provides cover for a shorter time, one year or less, against regular types of loss, like motor and home insurance policies. The cash flows and profits that



### Key facts about the UK insurance industry

- There are **379** life insurance companies in the UK.
- There are **903** general insurance companies.
- The insurance industry contributed **£29bn** to UK GDP in 2012.
- It paid **£11.8bn** in taxes in 2014.
- **334,000** people are employed by the industry in the UK.
- The majority of UK consumers purchase **at least one** general insurance product.
- **3m** consumers have pet insurance, 95% of which is for a cat or a dog.
- General insurance fraud cost **£1.3bn** in 2014.
- Investment and savings policies paid out **£40.1m** per day in 2014.
- There were **22,000** long-term care policies in force in 2014.

Source: ABI

these business models generate can be hard to understand, especially as complex assumptions are used, which are hard to communicate clearly to financial markets. Despite large differences, many of the regulatory and accounting rules for insurers overlap. Formulating rules that appropriately address these different businesses is challenging for the industry and for others trying to understand it. This is exemplified by the struggle to develop an international insurance accounting standard, which has been in process for over 18 years and has still not reached a consensus.

Along with changes to accounting, the way insurance companies are regulated, and the amount of capital they have to hold to protect against unexpected losses is changing and expected to grow. The Solvency II regime, a consistent regulatory framework across Europe with more limited ability for local interpretation, came into effect in January 2016. A European regulation creates challenges for insurers who often operate on a global basis.

Introducing the new regulation has been time consuming and costly. Ultimately, it will mean that customers will pay higher premiums, particularly for products which are riskier to the company, like annuities. In addition to the purely prudential costs, increased resource is needed to ensure compliance with new regulations. The Financial Conduct Authority (FCA) is also introducing more stringent requirements. Both will contribute to higher premiums as companies seek to recover and offset costs. This is exacerbated by the continuing difficult economic environment which is providing lower investment returns.

Insurers are starting from a difficult position when it comes to explaining to the world how they will face and deal with new risks that are emerging or becoming understood. This report explores some of those risks and shares insights from auditors with decades of experience in looking at the industry.

# Insurance – a social necessity

Continued

## Ten reasons why insurance is hard to explain

In this report we've focussed on four areas where auditors are able to offer insight into a changing industry. In addition to these areas, the following list highlights some of the complexities associated with insurance companies, and why it can be a particular challenge for them to communicate with the market and their policyholders about their financial position and performance. Auditors can offer many insights into these issues, but we have focused on four that may be less obvious.

1. Complex financial models are needed to capture and understand the risks the company has to deal with.
2. Assumptions and judgements about the future are necessary to estimate the value of assets and liabilities.
3. Tail risk means that it is hard to know when profits can be recognised on a portfolio of contracts as some claims can take a long time to emerge.
4. Lots of industry specific measures have been developed to communicate performance. Inconsistency and disparate application mean they can be hard to understand.
5. Companies need to hold long-term assets which are generally less liquid and hard to value.
6. The business model of insurance requires companies to relate unrelated things and take advantage of timing differences and opposing effects.
7. The industry comprises both life and general insurance which behave very differently, and therefore finding a common and consistent way to meaningfully report the performance of these different products is an enduring challenge for standards setters.
8. Companies have to reconcile differing regulatory priorities – for example holding more capital to protect against unexpected losses and providing better consumer outcomes, like lower prices.
9. There is global competition to be home to insurance companies. Industry leaders can choose between many locations like the Bahamas and the Cayman Islands which have favourable tax and regulatory regimes, compared with the UK.
10. New standards and regulations will not automatically bring clarity to the message of insurers. They must still work to communicate the complexities of their business to policyholders and investors.

# Flag 1

## What should society do for uninsurables?

New technology can give access to more data about customers, but personalised underwriting can challenge the ability of insurers to pool risk, which underpins the effectiveness of insurance cover. A consumer may become uninsurable if they won't share their data, fall into high-risk groups or do not generate relevant data.

Insurance depends on imperfect knowledge. Policyholders must believe they may be exposed to similar risks at some point. However, we are gaining both a greater understanding of the risks we face – thanks to better data about ourselves and our lives – and new technology which allows insurance companies to translate this data into underwriting and pricing risk. This means the way in which we buy insurance and interact with insurance companies is changing. The better our knowledge of these risks is, the more apparent it becomes that insurance is a social choice, and we must all believe in the value of the pool in order for it to work.

### What happens if people cannot get insurance?

Insurance is bought in the hope it never has to be used. If policyholders are unable to make insurance claims, problems are almost inevitable. It is vital that appropriate and affordable cover is available to protect us from risks we face in everyday life, but may not be able to bear the cost of alone. Individuals can suffer financial losses, which can be exacerbated by legal problems resulting from the insured event and there are costs to society, for example due to uninsured drivers. What this means is that the government will sometimes intervene to make sure that insurance is accessible to those that need it. Insurance and its cost can also be used to influence positive behavioural change. With appropriate checks, this should ultimately be a good thing for the average consumer. What benefits them will likely be congruent with a lower risk portfolio for the insurer.

### Get in the pool

The business of insurance depends upon enough people being exposed to broadly similar risks and

seeking broadly similar insurance cover. Whether cover is forced, like car insurance or buildings insurance for those seeking a standard mortgage, or through choice, a critical mass of risks and therefore policyholders is needed. This leads to a focus on portfolios rather than individual customers.

Theoretically, when accepting a specific risk from a policyholder the insurer should always look to charge the right price for adding that specific risk to the portfolio of risks pooled by the insurer. However, the extent to which the insurer can take into account each risk factor is limited. Risks are defined in relatively broad terms, so that the circumstances of large numbers of customers can be viewed as common from a risk perspective. When a policy is first issued, the focus is therefore on whether the customer belongs to a defined risk group. This might be based on biometric risks like age, occupation or marital status, or factors like where the policyholder lives or the age of their car.

The customer has little control, or even visibility of what portfolio they have been placed in by their insurer. There will also always be exceptions to these groups. For example, this might arise through the monitoring of driving activity through telematics or black box technology. While driving behaviours might reasonably be viewed as controllable, times of day at which journeys take place aren't always, for instance, shift workers who need to drive home late at night or early morning. If late night driving is identified as particularly high risk, perhaps due to association with drink driving, those who need to drive at that time for completely different reasons might find themselves discriminated against in insurance pricing.

With increased information available about individual customers, market segmentation can be increasingly granular, and groups of uninsurable risks are likely to be identified. How this sort of situation comes to be handled by insurance companies will also affect how much the customer feels their insurer respects them and their circumstances.

If individuals do not agree to share their data to feed into more personalised underwriting, they may be defaulted to a higher premium. Where they provide

# What should society do for uninsurables?

Continued

data which is unfavourable to their policy terms, cover may be expensive or unaffordable. Technology could, in effect, create an uninsurable class of people. There are and will continue to be significant issues which must be considered by companies and policymakers where technology and data move away from the mutualisation of risk to individual underwriting. For example, the government is introducing Flood Re, a scheme to ensure provision of affordable flood insurance cover. More difficult choices will present themselves in determining a fair price and level of cover for other controllable (and uncontrollable) risk factors.

## **Flood Re: not-for-profit reinsurance**

Flood Re could be a perfect example of the social purpose of insurance in action. As envisioned, the government scheme, which is due to launch in April 2016, would allow insurers to transfer the premium they receive for the flood risk part of home insurance policies on high flood risk homes to Flood Re. In return, the scheme would reimburse insurers for flood claims that they pay to their customers in relation to such policies. The aim is to ensure all households can access flood cover, and to keep the industry competitive in this area.

We have seen this with the introduction of Flood Re, where to support public policy, government intervention funded by the tax-payer is used to facilitate 'fair' access to cover for all customers, including in cases where a purely commercial judgement would be not to provide affordable cover.

Insurers already cross subsidise those at a higher risk of flooding, but an increasingly competitive market could put an end to this. The Flood Re scheme would replace this cross-subsidy with a statutory levy to create a level playing field across the whole insurance industry. New entrants would be prevented from gaining an advantage at the expense of existing insurers that have been selling high-risk policies at a loss. However, the scheme has not been without controversy, with exclusions and cost increases for all policyholders causing tensions.

## **What is fairness?**

Regulators also have a role seeking to ensure consumers have access to 'fair' pricing. However, this is not necessarily the same as making insurance more affordable and accessible. This raises a challenge: the more data can be used to differentiate individual customers from each other, the greater the risk that some customers' premiums become unaffordable, as their personal risk is so high. While that might be the right answer from an insurer's perspective, and an effective use of data, there will be increased focus on customer protection and maintaining insurance at a price that the customer can afford.

Competition should help mitigate the risks of creating an uninsurable class to some degree. This will depend upon how much control can be exercised over different variables. For example, if you live in a major city, you have little control over terrorism risk to which you may be exposed, or flooding risk where you live on a flood plain. In cases





where individuals are thought not to have control over the risks and insurance cover is considered essential, we have seen the government intervene or interpret terms to facilitate fairness.

### Change is good?

It is not certain to what degree the feedback loops facilitated by technology like telematics and wearable devices will meaningfully change behaviour, so they have a noticeable impact on consumers' choices. Technology must be used in conjunction with behavioural economics; financial benefit alone is not always enough to motivate people to take action (the lack of current account switching for example). Many consumers still have an uneasy relationship with data and handing it over to companies, when cyber risks and data breaches remain high on their radar. Currently insurers use sources like Experian data, but this may move on to things like a potential customer's social media activity and profiles and similar sources

which may be a concern for consumers. While people can behave in the most beneficial way, there will still be those who end up unable to afford the risk they represent. Policymakers, tax payers, consumer and insurance companies will be forced to consider when the wider group will still be willing to foot the bill to ensure that people are able to access appropriate and affordable insurance cover. The way we think about insurance will have to change if we wish for it to remain a social safety net. A conscious decision to move away from the long held individual underwriting model may be needed in order to fulfil this purpose.

### Nudge

The UK's Behavioural Insights Team, which has been replicated in other countries, has demonstrated how simple actions can be effective in incentivising behavioural change. The team found that interventions are more effective if they are done at specific times, perhaps due to increased motivation associated with certain circumstances. Insurers know a lot about their customers and will often be privy to information about life changing events which they could capitalise on.

The team found that reciprocity is a powerful influence. This was found both in terms of the most effective arguments to increase organ donation (what if it was you who needed an organ?) and increasing charity donations by investment bankers when they received some sweets and a personalised email. Vitality from Prudential rewards policyholders with cinema tickets and vouchers for continued motivation to improve their health and therefore, in theory, reduce overall risk to the insurer. The Behavioral Insights team also found that substituting similar behaviour rather than eliminating an entrenched one (for example switching from cigarettes to e-cigarettes) is more effective for getting a good result. Simple mechanisms like text message reminders to stay committed to worthwhile activities also served as an effective prompt. If insurers are able to 'make it easy' for consumers to change, they will not only benefit their customers but also improve their underwriting.



# Flag 2

## Do insurers still have the best data?

Data allows insurers to do business more efficiently and effectively, especially in a mass market retail space. Big data demonstrates how the behaviour of groups or segments of populations can inform consistent pricing, where bespoke products may be beneficial or needed and in the identification of fraud. It is vital to reduce claims leakage due to fraudulent claims and maintain the integrity of revenue by preventing and detecting fraud when consumers purchase insurance.

### Digital opportunity, data risk

Insurance companies used to be in the privileged position of knowing more about individuals than they probably know about themselves. In addition, they also knew all about similar people. As how we interact with companies changes, so does their access to proprietary data about us, meaning insurers may no longer have the best view of their customers. In *The way forward: insurance in an age of customer intimacy and Internet of Things*<sup>1</sup> the Economist Intelligence Unit found that insurers most fear disruption from non-insurance entities like Google and Amazon when it comes to keeping up with their customers.

The reality is that insurers may already be behind in the big data race, and that other companies have a lot more data about their customers. For example if you use a Tesco ClubCard when shopping, Tesco probably knows more about your health and life changing events like getting married, having a baby or developing an illness, than your insurance company. If they were able to use this data, and were inclined to set up an insurance business, the data they have to inform pricing certain types of risk would likely be envied. Threats to new business may be less likely to come from incumbents, but from new entrants able to better use customer information. Insurers need to make their ability to use data a differentiator, reducing their need to compete using marketing gimmicks, like meerkats used in television advertising.



### Know your customer

The long-term liabilities (cost of future policy payouts) of insurance companies are often determined by biometric risks (a specific type of underwriting risk related to human life conditions, death, disability, longevity, birth, marital status, age, number for children). What used to be about experience is now very much about data science. Technology is helping insurers find a new balance between biometric risks and their mortality exposure. Mortality exposure is increasing as people are living longer, so insurers know they are going to have to pay out more overall in pensions and life insurance policies. Given that there are multibillions of euros worth of such guaranteed contracts in-force, insurance companies will have to examine and potentially overhaul their business models to successfully navigate this



environment. One way to help cover this cost is by understanding the risk they're taking on better, by finding out more about the people they're insuring, for example through use of wearable devices and apps which inform them about their customer's health and activity.

By taking an innovative approach to service and price, insurance can remain a sustainable business. Some health insurers, for instance, are offering incentives to policyholders who share health and fitness information via apps and wearable devices. This has the potential to make the provision of insurance more precise and potentially better value for the policyholder. Technology allows a move away from the mutualisation of risk (the purpose of insurance) to individualised underwriting. This can

encourage policyholders to change their behaviour to reduce their personal risks and ultimately affect the level of premium they have to pay. It allows the insurer greater visibility and control of the risks they take on.

### **Making sure systems can keep up**

The channels to reach the customer are becoming more digital, particularly with the expanding use of mobile devices. One industry analysis predicts that digital interactions with financial services organisations will outnumber face-to-face by 250 to 1 in 2016 and mobile interactions will outnumber calls by 30 to 1.<sup>2</sup> In order to maximize on this shift, insurers must first tackle their digital deficit, which is not insignificant.

This is a challenge in an era of inflexible and aging legacy systems. The typical policy administration system is 15 to 20 years old, and they are getting in the way of doing business, rather than acting as an enabler. Migrating to new systems with modern user interfaces is one solution, but a costly one that brings with it significant migration risks. Instead, an increasing number of insurers are using robotics to bring together disparate legacy systems. Techniques such as robotic process automation (RPA)<sup>3</sup> provide a solution for extracting, compiling and processing information held across multiple systems, as well as updating them with new policy information. The upgrading of legacy systems is essential in order to analyse individual risks better and tailor products to customers.

A growing number of insurers are scaling up their analytical capabilities and, as a result, will be in a better position to use data in a more connected way. Meaningful insights can be drawn through more efficient use of data at virtually every stage of the insurance life cycle, from customer targeting to product design and pricing, underwriting, claims and reporting. It can also lead to new associated services, giving opportunities for more touch points. By working with employers as well as individuals there is a great opportunity to understand large groups of potentially similar individuals, which other organisations do not have the same access to.

### **Demand-led change brings risks**

Insurers need to innovate to produce what customers need and want, for example, cyber risk insurance. As a relatively new risk there is a lack of data and little knowledge to allow precise pricing. This increases the risk for insurers, whether through leaving themselves without sufficient premium to pay claims or being accused in future of unfair treatment of the customer through charging too much premium. Currently there is no consistent view, and government policy

# Do insurers still have the best data?

Continued

intervention is being considered. Some policies are being treated as tacitly including cyber risk despite no explicit mention of it whereas others explicitly exclude it, and some insurers offer separate cover. This leads to a lack of clear pricing in the market, which makes it more challenging for buyers, as well as the companies writing the policies.

Getting this right could be a very significant innovation. A stable market makes innovation easier. This will only become established if insurers are able to take pricing risks where they don't yet know what the 'right' price is. This is particularly difficult as retrospective review by a regulator might indicate that customers paid too much cover, as well as those where insurers incur unforeseen losses.

## Data and fraud

According to the City of London Police, insurance fraud currently adds on average £50 per policyholder: in excess of £2bn per annum. Cross-industry collaborations to combat fraud have resulted in much greater levels of cooperation and data sharing. As a result, fraud identification – both on the claims and application side – has improved and is often real-time enabled. Insurers are clearly alert to the opportunities, but more investment is needed.

Within the mass market retail space, big data – such as credit checking and motoring conviction

verification – is also being used to provide supplemental rating factors and help prevent and detect fraud. There is a clear desire to gain more consistency in terms of how risks are priced, which requires genuine, as opposed to fraudulent data to work accurately. Preventing claims leakage is another big area for insurers, particularly in personal lines. Here, better analytics could be put to work, optimising claims processes and identifying suspected fraud. This is a huge untapped source of value for many insurers, given that around 70% of the premiums charged can go toward paying claims.

Insurers looking to gain a competitive edge will use data to offer individuals more bespoke products. The challenge for insurers is to differentiate their offerings from what is already available and to come up with products that customers want to buy at key points in their life cycle. Everyone is getting better at data, and insurers are well placed to capitalise upon this, but brave investment decisions may be needed to ensure the business is ready. Insurers are closer to the consumer, but so are the competitors and potential competitors.

# Flag 3

## Taking out the insurance middle man saves costs, but at what price?

Enabled by technology, and driven by the desire to reduce costs, the middle man (broker) is being cut out of insurance, and is now the preserve of large specialist areas. Digital technology has made it easier for insurance companies to get closer to their customers. Even if people aren't buying online, most will do research and compare prices and features using the internet. The idea of visiting an insurance broker to understand what sort of insurance cover is most suitable would be foreign to the majority of millennials.

Technology usually empowers consumers: shared knowledge can enable cost savings, for example price comparison websites (PCWs) which enable you to choose a new energy provider or broadband package. However, when dealing with an industry that many people don't really understand, this democratisation of process can lead to uninformed choices which are harmful to the customer. This can range from buying an insurance product which doesn't cover them when they need it, or to paying more for a product with features they do not need.

Dealing direct means there is no one advising the customer in their own interests. An expert intermediary like a broker could prevent a customer from buying a product not matched to their needs. Now customers must rely on their knowledge and experience, and the standardisation of the processes at the insurer, or take advice.

### Dealing direct

Digital sales and PCWs can appear to make things simple, but mean that the information captured and input to the product selection algorithm must be limited, which affects consumer choice. These sites have had to become more transparent about how they are funded following intervention from

the Competition and Markets Authority<sup>4</sup>, but it is still not guaranteed that they will cover the whole of the market. The need to present a relatively quick snapshot to the consumer also means that differentiation between the details of insurance products must also be limited. A simple example of this is whether car insurance includes legal cover or a courtesy car as part of the policy or not.

### Reading the small print

While it facilitates an easy purchase, a simple sales process can increase the risk of mis-buying. If insurance was a simple product this would matter less, but customers do not always understand the insurance products they are buying. The claims response often does not fit with their expectation. The perceived lack of choice or options associated with certain types of products, for example preferred repairers for car insurance or authorised hospitals for health insurance, can make them feel commoditised. Instead of this simplifying the process, it can lead to less understanding. For example, customers often do not appear to understand some important features of the product they are buying. In relation to general insurance products, for instance, whether claims are paid on a new for old basis (and exactly what that means anyway), how losses are valued, and how excesses work.

Common policy terms like 'new for old' may appear to be fairly straightforward but do not always mean what the customer thinks. In addition, this process inevitably makes policies more one-size-fits-all, and while customers may think they are happy with that when buying an insurance product, they are rarely happy if treated as commodities when making a claim.

Even where the consumer is able to absorb the small print, they need to take ownership for it. The optimism bias is a cognitive bias that causes a person to believe that they are less at risk of experiencing a negative event compared to others. Even if we are able to understand that we may not always be covered, we don't work on the assumption that those excluded events or circumstances will be the ones that happen to us personally. This makes it extra hard for insurers to meaningfully communicate what can be complex interactions in simple terms.

# Taking out the insurance middle man saves costs, but at what price?

Continued

## New for old: sounds simple?

New for old cover replaces your insured item with a new version when something happens, versus compensating the policyholder for the cost of repairs or losses due to wear and tear. However, wear and tear deductions will be applied to things like clothes and bedding. The type of cover you choose might attract a different level of excess (voluntary and compulsory) and the overall cost of the policy, for example for contents insurance, will be affected by the insured amount. Accurately representing the value of your items to your insurer is important, but most people have little idea of this value.

## The advice gaps

One way to mitigate these risks is through advice, which can be particularly important when looking to buy a more complicated product, but there is great pressure on the provision of financial advice. This is a key issue for politicians and insurers. Citizens Advice has identified four advice gaps which exist for financial advice.<sup>5</sup>

The gap	What does it mean?
Affordable advice gap	People would pay for advice, but don't have access to advice at the right price.
Free advice gap	People want or need advice, but either haven't taken it, or couldn't access it.
Awareness and referral advice gap	Individuals aren't aware of the possibility of advice, or if they are, are not aware of how to obtain it.
Preventative advice gap	If advice had been offered before a financial decision took place, the individual would be in a better position (perhaps more relevant to debt than insurance products).

People need access to unbiased and impartial advice, which helps them understand which products are suitable to manage their financial needs, often thinking a long way into the future. Insurers have the knowledge, skills and experience to provide this advice, but at a time when the industry is working



to restore and maintain trust they must do so in a way that does not incentivise mis-selling or otherwise improper behaviour.

## Risk and advice

Autonomy and freedom of choice have been prioritised by policy decision makers. Recent changes in the UK have had drastic effects on the long term insurance market. Pension freedom means individuals can now choose what to do in retirement, rather than being required to purchase an annuity. It is also more complicated for customers to make decisions about financial products. With no fixed retirement age and increased longevity the variables are less certain.

With longer term policies like life insurance and investments, the risks are exacerbated as insurance companies adapt long established products to ensure they fit current economic circumstances. In some countries this happens by placing a greater emphasis on selling and marketing unit-linked



products (an insurance policy and an investment in one product, meaning that the policyholder takes on some of the market risk); in other countries there is more attention for pension products with defined contribution features. What both of these do is transfer more investment risk to policyholders. Taking on less risk themselves makes it easier for insurers to deal with a challenging business environment and regulatory intervention in the short term, but insurers also need a clear sales process to ensure the customer knows the risk they are taking on. Policyholders must also be sufficiently aware and informed of their own risk appetite and the risks associated with the product.

### Regulatory hindsight

In order to properly meet customers' needs, companies must innovate to accommodate new risks and requirements. However, regulation can be a barrier to innovation. The FCA's operational objectives seek to enhance trust in the industry and in current and future regulation. The industry

recognises that this is positive for business, but regulation can also impact strategy in ways that may be unintended and which are not positive. For instance, the use of hindsight in reviews of legacy products, sales processes and thematic work can affect insurer's risk appetite and product planning. This leads to insurers feeling constrained about offering advice in particular when they may be subject to a hindsight test in future. This may be in part why innovation is pushed to areas outside of current regulation.

### Ownership

Against a background of increasing difficulty in providing personal financial advice, which can be expensive where truly personal, it is also difficult for individuals to know or see the difference between advice and guidance, especially when they have never needed to take advice before. This means there is a greater responsibility on insurance companies to communicate with the customer, provide information and tailor products to their needs, but also for the consumer to be more informed. Responsibility for consumer education sits with the consumers themselves, policymakers, regulators and insurers. In order for educational efforts to be a success, consumers must first be engaged, a challenge which companies are starting to tackle, but with some way still to go.

Combatting these risks requires a joint effort. Encouraging ownership of circumstances and risks is a good thing for individuals and society; however, there must be a ready supply of help for those who need it. Insurers must also work to empower their customers to make good choices, and become interested in the products they are buying. This is happening to a limited extent with gamification, for example through sites like Sureify in the US and Aegon's Retire Ready platform in the UK which present insurance needs and concepts in simple chunks on easy to understand platforms without overwhelming the customer with warnings and small print right away. These positive actions and the increasing use of behavioural economics by companies and governments can help engage people with their insurers in a way they have not been able to before, without the need for a qualified intermediary.

# Flag 4

## How does the new normal change insurance business models?

Many people believe insurers make profits from their underwriting activities, ie, the extent to which premiums received exceed the claims paid. However, profits from the industry are in fact largely generated by investment. For example, motor insurance has not made an underwriting profit for over two decades.

The insurance business model means that companies do not simply make money from charging premiums for customers, but from pooling those premiums to buy investments. Premiums are received before claims are paid out, and companies have sophisticated methods of estimating the value of claims which will be made. Where they are less able to do this, for example in predicting natural disasters, they can buy reinsurance to protect themselves against some of these risks.

Investments are meant to generate a return which should allow the company to make a profit on top of paying out claims and re-investing in the business. This is particularly crucial for long-term insurers, but also for short-term insurers where a consistent pool of short-term contracts provides them with the cash flows to invest in longer term assets as well. The prolonged low interest rate environment in the UK, Europe and the US has meant that it has been, and continues to be challenging to generate these investment returns that the business needs to do well.

However, the low rate environment has been good for consumer spending and insurance companies can still benefit from these favourable economic conditions. For example, general insurers feel the benefits of a buoyant housing market, as this can have a corresponding demand for big-ticket items (cars, fridges, washing machines) which require insurance cover, but this may be unlikely to offset a lack of investment return.

Against this backdrop, capital requirements, changing regulations and an uncertain accounting framework add costs to the business and pressure to the industry.

Accounting and regulation dis-incentivises insurance companies from taking on volatile assets, which can lead to profitability going up and down meaning that they do not get credit for creating value in the longer term. This could include alternative assets, like infrastructure and mortgages (both through issuing products like equity release mortgages and through mortgage backed securities). However, for the latter, there are both conduct (for example the structure of the sales process) and prudential risks associated with issuing such products.

Costs of compliance, for new structures like the Senior Managers Regime, increasing FCA regulations, as well as Solvency II and the costs associated with prudential regulation further affect profitability.

### The search for yield

The business model means insurance companies are well placed to invest in vital projects like infrastructure. These projects provide a return over





a longer period and require large sums, compared to many others. In a low rate environment this can seem increasingly attractive and recent changes to Solvency II regulation have been made to ensure that insurers are able to make such investments without being required to hold punitive amounts of capital to compensate for the risks associated with such projects.

Reduced investment income, meaning the company makes less money from each product, has had serious consequences for some. Some long-term products offer the policyholder a guaranteed amount of money like income protection products and defined benefit pensions. These products, which are underwritten when they are taken out, pose a particular risk. Inability to generate returns from investing in assets, (which has always been a key part of long-term insurance business models) may mean earnings are too small to meet the companies' long-term obligations.

### Reinsurance and alternative capital

Due to the size and complexity of some risks, some insurers take out their own additional insurance as added protection for themselves. When insurers insure themselves against a risk it is called reinsurance.

Lloyd's of London is a specialist insurance market in London which was founded in 1688. The largest part of its business is reinsurance, but they also do specialist insurance covering everything from satellites to sports stars' legs.

The influx of capital into the property catastrophe reinsurance industry, which protects against natural disasters like hurricanes and tornadoes from pension funds and other institutional investors, has gained pace over the past five years. Investing in insurance companies, especially those covering things like hurricanes and tornadoes, can earn investors above market returns as they are taking on a higher level of risk. However, as these risks aren't highly correlated with wider market movements due to stock price volatility or interest rate changes, it means that investors' risks across their portfolios are more diversified. This desire for returns has made reinsurance cheaper and displaced capacity from traditional providers, like Lloyd's of London, into other classes of business.

Products which suit customer needs and also provide a return for the company are increasingly difficult to design. There is the additional context of the so-called savings gap, which is a cause for concern for governments, regulators and especially those approaching retirement. The challenges this presents should not be underestimated, and may involve not only new products, but also re-educating consumers around the appropriate use of products like equity-release which have gained a bad reputation in the past, but may help individuals who have assets but not savings. Insurers must also remain mindful of their social purpose helping to protect people against financial risks they face in the future, such as lack of income from other sources, whether that is a reduced state pension due to policy changes, or losing their job.



# How does the new normal change insurance business models?

Continued

## Insuring the insurers

However, despite confusion and uncertainty facing the industry, the capital shortage seen in the financial crisis has passed and new capital, particularly in the non-traditional reinsurance market is expanding. This is in part due to many companies losing less than expected in the face of a global crisis. Mergers and acquisitions are also taking place again, both large scale (Aviva and Friends Life) and in the London (Lloyd's) market. However, the UK's strength as a home for insurers continues to face competition from other insurance centres like Bermuda and Switzerland.

These factors are not just problematic for long-term insurance companies who require assets that they can hold over a long period to back their long-term contracts like life insurance policies, but now also increasingly for general insurers. Where insurance companies would previously pay out a lump sum to a policyholder who required support after a life changing injury, for example in a car accident, the court decided in 2005 that payments could be provided over a longer period, known as a periodic payment order, as this is likely more secure than investing the lump sum.

We cannot assume a change in interest rates, let alone a quick return to pre-crisis levels, so insurers will have to work with policymakers and consumers to ensure that they are transparent about the products that they are providing, and how they may or may not meet their needs, both now and in the future.

## PPOs – changing the way the economic environment affects general insurance

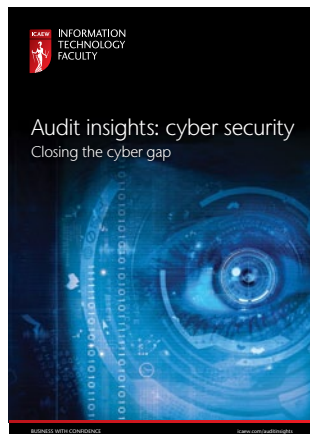
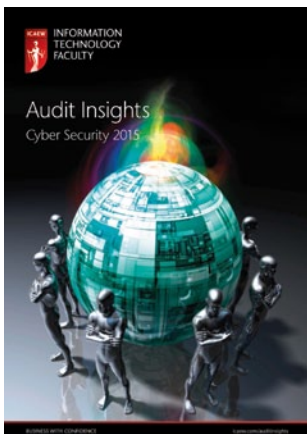
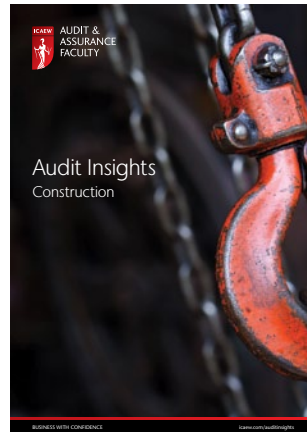
General insurance, while usually simpler is also affected by new laws and regulations, and in certain areas is gaining common ground with life insurance. Insurers are being affected by the use of periodical payment orders (PPOs), which UK courts were given the power to enforce in 2005.

The orders are used to settle large motor and liability claims, providing an annuity like payment to the policyholder. General insurers are less equipped to deal with these sorts of settlements which come with substantial interest rate risk, a need to understand the difficulty of estimating how long payments will need to be made and future life expectancy (where there is not as much available data) as well as managing investments to ensure there are sufficient cash flows available to meet PPO liabilities as they fall due.

In 2012, the Institute and Faculty of Actuaries estimated 10% of claims valued at £1m–£2m were settled as a PPO, and 70% of claims between £5m–£10m. These claims accounted for 20% of general insurance reserves, or up to 55% including incurred but not reported (IBNR – the total amount owed by the insurer to all valid claims which have not yet been reported) claims. This is an area that regulators are giving increasing attention as the industry seeks to understand the full impact. The increasing use of PPOs creates new challenges for insurers in pricing products, measuring them for financial reporting and in calculating regulatory capital requirements.

- 1 The Economist Intelligence Unit, *The way forward – insurance in an age of customer intimacy and Internet of Things*, [http://www.sap.com/bin/sapcom/en\\_us/downloadasset.2014-10-oct-15-10.the-way-forward-insurance-in-an-age-of-customer-intimacy-and-internet-of-things-pdf.bypassReg.html](http://www.sap.com/bin/sapcom/en_us/downloadasset.2014-10-oct-15-10.the-way-forward-insurance-in-an-age-of-customer-intimacy-and-internet-of-things-pdf.bypassReg.html)
- 2 EY Global Insurance Outlook, [http://www.ey.com/Publication/vwLUAssets/ey-2015-global-insurance-outlook/\\$FILE/ey-2015-global-insurance-outlook.pdf](http://www.ey.com/Publication/vwLUAssets/ey-2015-global-insurance-outlook/$FILE/ey-2015-global-insurance-outlook.pdf)
- 3 Robotic process automation (RPA) allows employees in a company to configure computer software to capture and interpret existing applications for processing a transaction, manipulating data, triggering responses and communicating with other digital systems.
- 4 Some sites were found to present some products in favourable locations on the page in exchange for payments.
- 5 Citizens Advice, *The four advice gaps – exploring the different gaps in provision of and access to free and paid money advice*, <https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/debt-and-money-policy-research/the-four-advice-gaps/>

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