



Association of British Insurers

INSURANCE IN THE UK: THE BENEFITS OF PRICING RISK

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How insurance deals with risk

Insurance protects people and businesses against the risks associated with everyday life. It provides financial compensation to help the insured, whether a person or a business, recover from a loss.

Without insurance, people would be less likely to:

- buy their own homes, since a fire or flood could destroy their investment;
- drive a car, since a single road accident could result in them being sued for a large sum;
- start their own business, since they could be completely responsible for the cost of an accident, fire or theft.

Insurance is also an excellent tool for helping people to assess, manage and reduce their risks.

How does insurance work?

Insurance deals with the risks of unforeseeable events. The basic principle of insurance is that the losses of the few are paid for by the premiums of the many.

Insurance does not work in exactly the same way in all countries. There is a spectrum of insurance pricing, and different countries sit at different points of the spectrum. At one end, the premium is calculated according to the risk posed by the individual. Insurers will look at particular characteristics – called rating factors – and assign that individual a level of risk. The higher the risk, the higher the premium. At the other end, everyone pays the same premium regardless of their individual circumstances. In both cases, premiums are pooled and any claims are paid out of the collective pool.

The extent to which premiums are based on the risk of the group rather than the individual risk depends on a number of factors, including whether there are any restrictions on the amount of information an insurer may collect about a particular risk, and the cost-effectiveness of collecting

that information. The less information held about an individual risk, the less the premium can be tailored to that risk.

The number and types of restrictions on information that can be used by insurers to rate risks differ between countries. Governments which impose restrictions usually do so with the aim of avoiding perceived unfairness, making sure that everyone pays the same premium for the same type of cover. However, where bad risks pay the same premium as good risks, there is less financial incentive on the bad risks to modify their risky behaviour.

Also, the good risks are unfairly penalised by having to pay higher premiums than they would otherwise do in order to subsidise the bad risks. And, as premiums become more expensive, some of the good risks may choose not to purchase insurance, leaving a higher proportion of bad risks in the 'pool' and pushing premiums up even more.

In the UK, there are relatively few restrictions on the number and types of rating factors insurers can use. The UK insurance market is therefore very competitive and is an innovative user of risk pricing.

Why risk pricing is good for consumers

Insurers want to be competitive. They can be most competitive if the premium they charge is appropriate to cover the risk posed, but no higher than necessary. Insurance companies have an incentive to 'risk price' as much as possible - using more, and increasingly sophisticated, rating factors so that they can accurately predict the probability of a claim, and the likely cost of that claim.

Consumers benefit from competition in the insurance market. In a competitive market:

- the prospect of lower premiums encourages consumers to reduce their risks where they can;
- the safer behaviour of the insured means average premiums are often lower; and
- there is greater choice for consumers between products and providers.

Risk pricing incentivises safer behaviour

Risk pricing allows insurers to set a premium that reflects the likelihood that the insured will make a claim, and the probable size of that claim. The less likely a customer is to make a claim, and the lower the value of that claim, the lower their premium will be. There is therefore a financial incentive for customers to reduce their risks.

While there will be some rating factors people cannot change – for example, their age or gender – there are others that they can improve.

Motor Insurance

Insurers use a range of measures to encourage motorists to drive more safely. For example, lower premiums are usually available for drivers of cars with smaller engines or security systems, and discounts for drivers who complete additional training courses are common. These discounts are successful in encouraging motorists to think more carefully about safety – over 50% of drivers who complete the Pass Plus training course, which teaches new drivers about a wide range of hazards, do so because of the insurance discounts¹.

There is evidence that risk pricing does encourage safer driving. In Canada, two different systems of motor insurance operate. While three provinces allow risk pricing, the other seven have pricing restrictions which mean that everyone pays the same basic insurance premium. In the provinces where risk pricing is allowed, the chance of being involved in a fatal road crash is almost 20% lower than in the more heavily-regulated provinces².

Life Insurance

Activities like smoking significantly increase the risk of premature death. 114,000 people in the UK die from smoking-related conditions every year, accounting for one-fifth of all UK deaths³.

Because of their greater health risks, smokers frequently pay up to twice as much for their life insurance cover compared to non-smokers. Over a period of 30 years, a smoker will generally pay up to £6,000 more than a non-smoker on a £100,000 life insurance policy.

Health Insurance

Health insurers often reward customers for leading a healthy lifestyle. Savings of up to 25% are available for individuals who eat healthily, exercise regularly and do not smoke.

In addition to financial incentives, many insurers also provide help and information to people wanting to improve their health, such as advice to stop smoking and discounts on gym membership.

Employers' Liability Insurance

All employers are required by law to have employers' liability insurance. This covers them against claims made by employees who have been injured or made ill by their work where the employer was at fault. There are a number of factors that influence employers' liability premiums. While the key ones are the size and type of the business, risk management procedures can also affect the premium. A firm with effective risk management systems in place could enjoy a lower premium than one without.

The Association of British Insurers provides advice to businesses on improving their risk management systems through its scheme *Making the Market Work*.

Household Insurance

While four-fifths of the general public have window locks fitted in their homes, only one-third of burglary victims do⁴. The more secure the property, the less likely it is to be burgled.

Many insurers offer lower buildings and contents premiums to homeowners with window locks and burglar alarms, in recognition of the reduced crime risk associated with a more secure property. In some cases, insurers make these security devices a condition of cover.

Risk pricing leads to lower premiums

A benefit of safer behaviour – aside from avoiding the incident in the first place – can be lower average premiums.

If you reduce the number of claims you make, your premium may follow suit. This is because your insurer will take your claims history into account when setting your premium. If you have been involved in no or few accidents in the past, insurers will view you as a better risk than if you have been involved in many. Of course, other risk factors may mean that your premium does not fall year-on-year, but a history of fewer claims should mean that it is lower than it would otherwise have been.

Motor Insurance

No-claims discounts in motor insurance are an example of safer behaviour leading to lower average premiums.

Motor insurers in the UK offer premium discounts to those policyholders with claims-free records. The level of discount allowed will vary depending on the particular product, and the provider. 60% discounts for four or more consecutive claim-free years are common.

1 *Pass Plus: ten years on – an ABI review of the evidence*, ABI, 2006

2 *Revealing research on auto insurance*, Mullins, M., Fraser Forum, 2004

3 *Smoking Statistics: Illness and Death*, Action on Smoking and Health (ASH), September 2006

4 *British Crime Survey*, 2004/05

Risk pricing encourages insurers to innovate

Insurers are always seeking new rating factors which will help them compete more effectively on price and product. As more sophisticated rating factors are found, insurers find new ways of catering for segments of the market that were previously uninsurable.

Private Medical Insurance

Thirty years ago, many people who had suffered from cancer could not purchase Private Medical Insurance. However, a better understanding of the disease has enabled insurers to identify rating factors that allow them to differentiate between risks within groups of cancer sufferers. Today, there are many Private Medical Insurance products available to people with cancer.

Similarly, if an individual had been diagnosed with diabetes, the condition would have been completely excluded from the cover. This is no longer always the case today; cover is available depending on the type of diabetes, the treatment necessary, and lifestyle factors.

In both these cases, if risk pricing were restricted, the ability of insurers to find cost-effective ways of insuring these groups of people would be limited. This would reduce the number of products and providers in the market.

Travel Insurance

Because of the specialist underwriting expertise required to assess the risks involved in providing travel insurance to people with cancer, not all providers in the market will cover customers in all cancer cases. However, as insurers learn more about advances in treatment and diagnosis, more and more provide cover to people with cancer. Many companies assess each risk on a case-by-case basis, taking into account factors such as the date of a customer's diagnosis and the kind of treatments the customer has had.

There are also a variety of specialist insurance providers in the market who cater specifically for people with a history of cancer. These insurers can cover people with current active cancers and even cancers that are incurable, as well as people with a past history of cancer.

Household Insurance

Many UK insurers have invested in improving their regional flood modelling. New digital maps are used to pinpoint the risk of river flooding to individual properties. Previously, the lack of good quality information on the risks of flooding left many households uninsurable. One insurer estimates that more than 600,000 properties in flood risk areas are now able to obtain insurance due to the information provided by their flood map.

Motor Insurance

Two insurance companies in the UK have launched telematics-based insurance. This uses a 'black box' which is installed in the customer's car to monitor how the car is used. For example, the black box

may record at what time of day the car is driven, how many miles are travelled, and what types of road are used. The customer will then be charged according to their actual usage of the vehicle.

In this instance, competition incentivised insurers to develop a more sophisticated method of pricing risk according to driving habits rather than just personal characteristics. This can make insurance more affordable for safer drivers within traditionally high-risk groups, for example, young drivers. The two telematics-based products currently available for young drivers charge a higher premium for those driving at night – when their risk of an accident is greatest.

One insurer estimates that young drivers taking advantage of their telematics-based product save up to 30% on the cost of a traditionally-priced product⁵.

⁵ <http://www.norwichunion.com/pay-as-you-drive/pricing-young.htm>

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