



The Right to Underwrite

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CRO FORUM

Table of contents

Introduction	2
Differentiation versus discrimination	3
Viability of products and adverse selection	4
Implications for risk management	5
Future developments	6
Conclusions	7

Introduction

The insurance industry has shown the ability to adapt to many changes in the external environment, performing its core function of absorbing risk and providing financial security/stability for social benefit. This social benefit allows businesses to flourish, and individuals to carry out their everyday lives with protection against unfortunate events. This ability to adapt should not be assumed to be applied to any possible change.

Recent and pending EU Anti-discrimination law (Directives, European Court of Justice ruling) poses a major challenge to the insurance industry as it restricts fundamental insurance pricing. In this paper, the CRO Forum expresses their views on how such legal framework affects insurers' risk management practices, and looks into potential consequences in a voluntary insurance market. There have been several papers and analyses on this topic by industry participants and other stakeholders¹, highlighting its consequences for the customers and insurance companies. This CRO Forum paper looks into the impact on risk based pricing, risk management, and the consequences for consumers and providers. We explain why the ability to use the relevant risk measures is essential for good risk management and viable insurance products with a reasonable price.

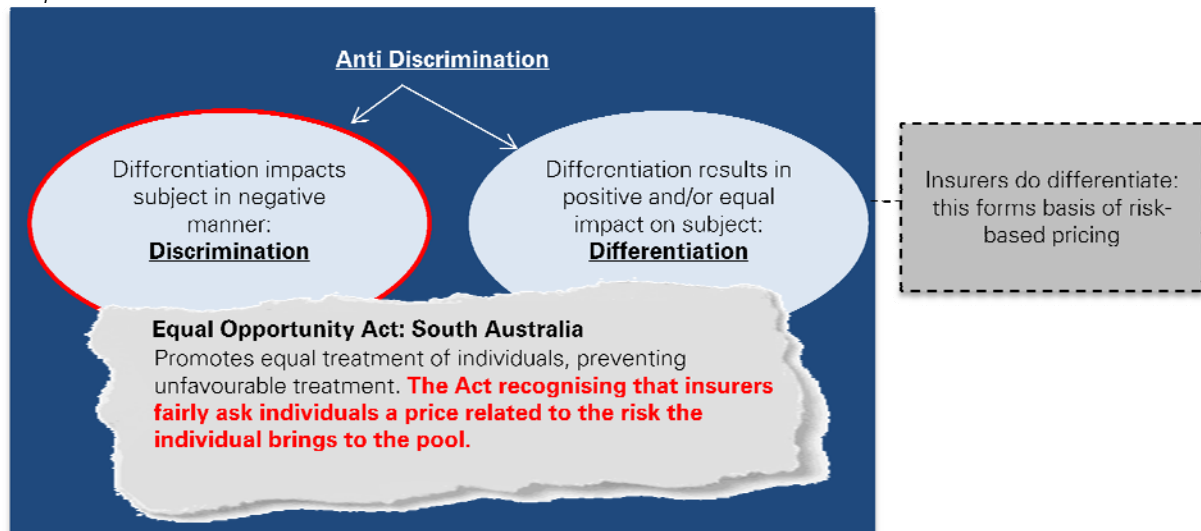
¹ (i) The impact of a ban on the use of gender in insurance, December 2011, Oxera, (ii) The use of gender in insurance pricing, February 2011, Insurance Europe.

Differentiation versus discrimination

The word “discrimination” (see also graph 1) is usually associated with a negative bias and synonymous with prejudice. However, the true (technical) sense of the word is neutral, it simply designates the ability to recognize differences (differentiation). Insurers have traditionally pursued actuarial fairness, by which policy-holders are charged a premium in accordance with the risk they bring to an insured pool.

In the vast majority of cases, the underwriting process results in risks being allocated to an appropriate, pre-determined pool of standard risks, i.e. the applicant pays only the standard cost of cover as determined by the pricing actuary for that pool. For private insurers, the freedom to quantify and to group similar risks together, based on selection criteria that are actuarially justifiable, is fundamental in establishing a homogeneous risk distribution within the pool. This approach may not produce equal prices between the members of pools, but it is equitable and guarantees that the consumer pays fair and competitive premiums based on the risk he or she brings to the pool.

Graph 1: Anti discrimination – differentiation versus discrimination

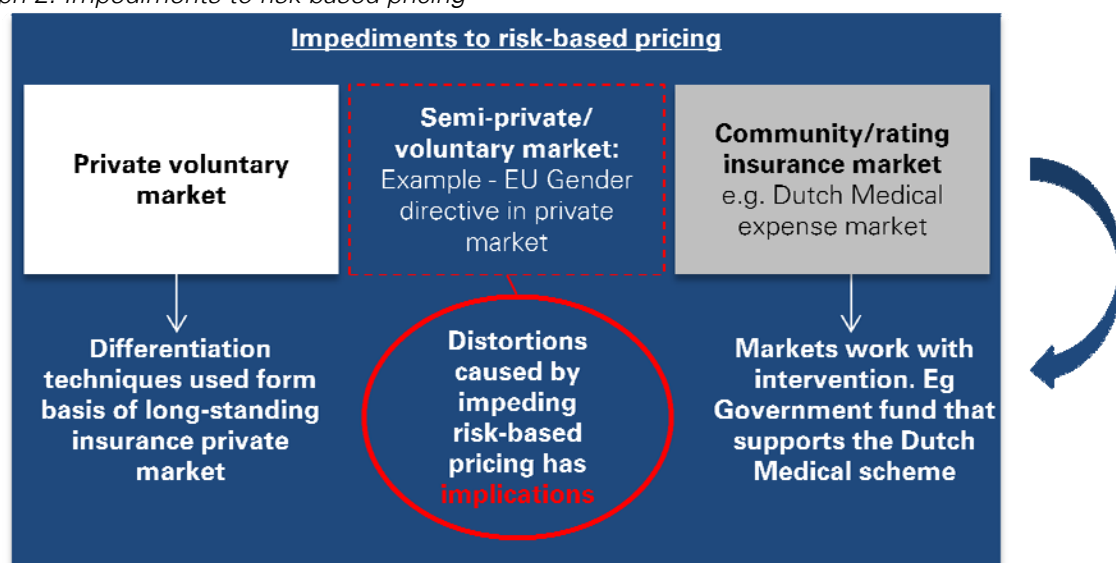


Underwriting involves differentiation between people on the basis of a risk assessment. It is essential that EU law acknowledges that the use by insurers of actuarial evidence or medical knowledge to support sensible underwriting decisions based on sound analysis of relevant risk factors does not constitute discrimination where the factors are relevant for the assessment of risk. Where EU law prohibits the use of this information for insurance pricing purposes, the information should still be made available to the insurer as this is used for reserving and effective risk management. Differentiation between different groups of risk is necessary in order for the insurance market to function effectively.

Viability of products and adverse selection

Some insurance products, notably private medical insurances (PMI) in some countries (e.g. Ireland, Australia, basic health care in The Netherlands) have no, or extremely limited, risk based differentiation. Experience and theory shows that where insurers can not adequately differentiate using appropriate risk factors a product is not viable at a market level unless there are strict conditions on availability (such as compulsory cover or heavily restrictive conditions and benefit limits). In some cases even these may not make for a viable market (see also graph 2 for a summary), which is explored in some depth by Groupe Consultatif Actuariel Européen². Several PMI markets work on this basis, some other products such as employer provided group life also have risk neutralising mechanisms. When the product is voluntary and/or benefits and conditions can be individually selected, adequate risk differentiation is a necessary condition for product viability.

Graph 2: Impediments to risk based pricing



A failure to recognize the differences in risk presented by individuals and to control them through underwriting measures or price variation can lead to adverse selection (riskier individuals purchasing more insurance, and less risky individuals purchasing less insurance) or in the extreme to unavailability of certain insurance products. Changes in purchase of insurance cover could affect the underlying pool of risks such that average claim levels increase.

Example – Annuities

If all annuity rates had to be the same no matter the age of the applicant, the annuity would be more attractive to younger consumers, because on average they will pay less relative to the expected number of years of benefit from the policy. For the insurer a challenge arises when the policyholder is free to decide whether or at what age to buy an annuity policy. The same argument goes for other life products as whole life or term insurance policies. In the case of a voluntary based insurance market adverse selection will exist resulting in an unsustainable insurance market.

² Use of Age and Disability as rating factors in Insurance - A position paper on why they are used and what the implications of restricting their use would be. Edited by Jim Murphy, December 2011.

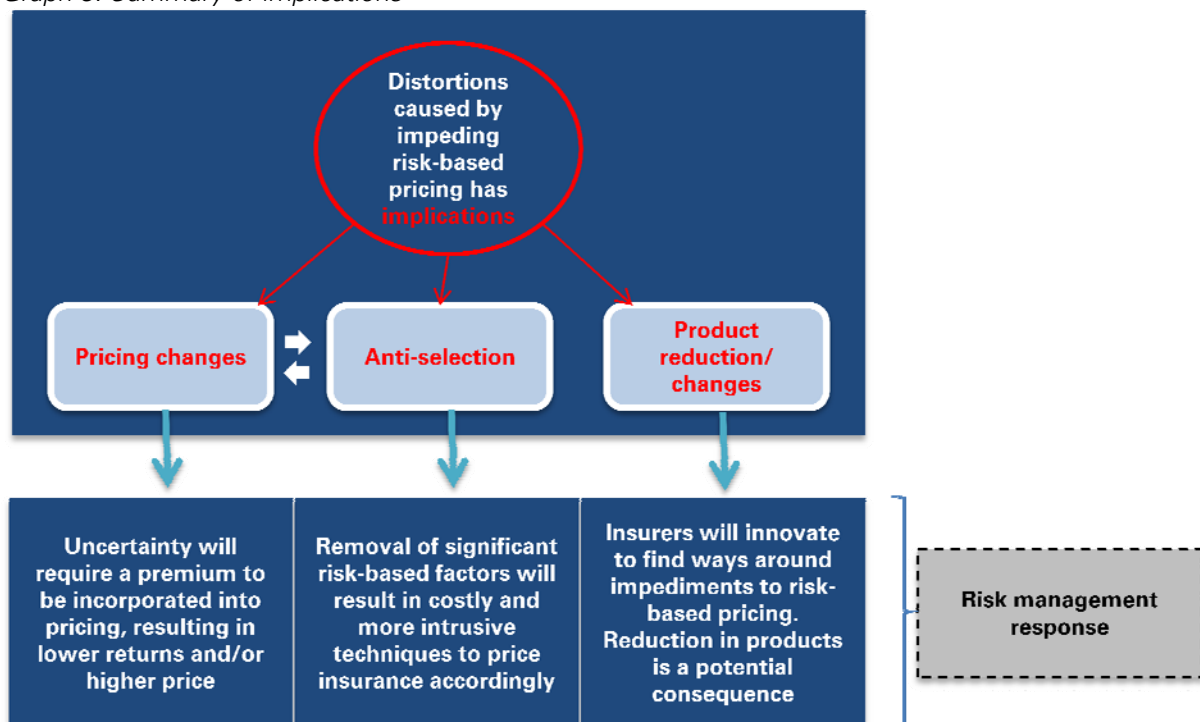
Implications for risk management

Insurers hold assets sufficient to cover possible claim outgo in all but the most adverse circumstances. This requires the quantification of a best estimate of claim outgo and the holding of additional assets (regulatory capital requirement) to meet adverse outcomes. To do this they must divide the risk into homogeneous groups and make calculations that accurately reflect the expected cost of each group. For example even where a premium rate for a death benefit is the same for male and female it will be expected that the firm will have information on the benefits segmented inter alia on the basis of gender and to apply different expected claim costs according to gender.

It is vital that an insurer can access the necessary data with which to evaluate the true risks both for pricing and for ongoing security of the policyholders. Where data is found to be inadequate to assess the amount of assets required there will be strong pressure from directors and supervisors to obtain better data and in its absence to include prudent margins for the uncertainty introduced. Unless corrected, e.g. by higher premiums, lower returns and/or higher prices can lead to reduced availability of capital and limitation to product availability.

From the prudential (soundness) perspective governments require insurance supervisors to ensure that firms do not put their solvency in peril through inadequate product design, underwriting, pricing or reserving. The practices outlined above relating to reserving, capital and data are reinforced for European firms in the EU Prudential requirements known as Solvency II. The objectives of regulatory requirements under which insurers are required to hold sufficient *risk-based* capital for the risks they pursue would be frustrated if insurers are not allowed to price adequately or to access adequate information to assess reserving and capital requirements, e.g. reserves and risk capital for longevity are driven by the risk differentiations of age and gender.

Graph 3: Summary of implications



Future developments

The industry has a proven track record for surviving change successfully. However, the challenges in risk based pricing will result in:

- additional costs being borne by society;
- a potential change in the product landscape;
- challenges in appropriate pricing (with an impact on reserving and risk management).

Insurance companies will face considerable costs for research and development of new underwriting factors and implementing these new approaches to understanding risks. Additionally the time taken to purchase insurance may increase.

Example – increasing complexity

To illustrate the above-mentioned point on time, it currently takes several times as long to purchase household insurance on the phone in certain countries as it does in the UK due to a higher number of rating factors, and we may move towards such a model across Europe.

As an industry we encourage the trend towards risk based pricing. If differentiation with respect to certain risk factors will be prohibited, insurance companies will need to find other ways to price risk. On the whole, this will have a negative impact on the industry, with the impact varying per line of business. In the non-life space, the insurance industry is likely to successfully navigate these changing regulatory climates, and continue to service consumers by absorbing risk from their lives, albeit at a potentially higher cost to society. However, for term-life insurance where payment depends directly on death or survival, age and disability are acknowledged as fundamental factors and effective substitutes are not likely to emerge and the impact to the industry and consumer would be far more significant, leading to the withdrawal of products and even some actors from the market. Furthermore, products providing disability related benefits will present particular challenges for life and non-life insurers.

Example – Risk and behaviour

If we consider motor insurance, we expect a trend towards a more specific individual-based pricing mechanism, perhaps ushered in with the extended use of telematics. Monitoring drivers' individual behaviours and pricing for actual driver history will allow an insurance company to improve the risk sensitivity of pricing. The cost of installing such devices in all new cars, customer adoption, data reliability and the potential of adverse selection all remain concerns. However there are potential upsides to consider in terms of pricing for risk, the incentive to improve driving by knowing it can influence the cost of insurance and potentially life saving situations where information can be passed on to emergency services through telematics devices. All these reasons suggest it may be in the industry's best interest to promote the adoption of new technology, once tested and considered appropriate.

The travel insurance market faces different challenges, especially around medical cover when travelling, and similar considerations apply to group medical policies where age remains a fundamental rating factor for now.

From a household insurance perspective, lifestyle is likely to become of greater importance and insurers are more likely to focus on the exact costs of insurable items. Customers may find this invasive (additional questions, etc) but this will provide more accurate underwriting and therefore benefit consumers in general.

Conclusions

- Risk differentiation is essential for the continuation of voluntary private insurance products. A ban on the use of relevant risk rating factors would put the current model at stake, leading ultimately to the withdrawal of some products and actors from the market.
- In some cases banning a risk factor may simply result in a redistribution of costs among the insured, in others it can destabilise a product and lead to antiselective spirals and even ultimately product withdrawal. Furthermore it will impact risk modelling as the underlying data might change, as well as the relationship between risk based pricing and risk measuring.
- Removing some risk factors from a product design or pricing may require imposing market controls to enable a sound market. Anti competitive legislation means this must be put in place by government not the industry.
- Insurers will seek adequate control of risk, where necessary using new approaches to risk differentiation. The stabilising measures available to insurers may result in policyholders facing extra costs (through less well controlled claim costs, higher loadings for risks and expenses), reduced coverage or more intrusive and burdensome underwriting.
- Good risk management by the public sector (i.e. governments and other legislative organisations) requires careful consideration of the consequences for the insurance industry of all actions which restrict risk differentiation.



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