think piece
Promoting debate and fresh thinking in the financial services industry

Risky Business: Insurance and Society

Andy Haste

Summary

- This article, the first of a series of four on risk and insurance, explores the basic elements of risk management, the value it can add to peoples' freedom and choices and the future challenges that insurers face in taking on and assessing levels of risk.
- Insurance provides an important and often forgotten social value to consumers and businesses. Its benefits range from providing security in the face of potentially catastrophic losses at home or abroad to providing freedom from liability allowing firms to explore new and dynamic fields.
- While the basic principle of providing peace of mind has stayed the same for over 300 years, the processes for doing this have become increasingly sophisticated. New techniques such as accurate flood mapping and telematics technology have resulted in more competitive propositions in both commercial and personal lines.
- Insurance has also had the effect of influencing behaviour, such as incentivising safer or more climate-friendly consumers or more sustainable business practices.
- Looking ahead, insurers and government will need to develop mutual working and understanding. In the area of climate change, underwriters must contend with the need to develop realistic risk modelling for related scenarios despite not being aware of their full impact or likelihood. Meanwhile, policy makers must consider the unintended consequences that otherwise well-intentioned legislation could hold for insurers.

Number 23 (August 2009) **"Risky Business" Series Number 1**

CII Introduction: the insurance industry provides a long-standing and often forgotten role of helping people and businesses do things without the fear of catastrophic loss should something go wrong. How can this be achieved in a sustainable manner? Does the industry use the most sophisticated techniques available to ensure the highest standard of service? How can insurance be used as a force to "nudge" positive customer behaviour? This special series of four Thinkpieces entitled 'Risky Business' explores aspects of risk and insurance from the perspective of various stakeholders. In this first piece, Andy Haste, Chief Executive of RSA Insurance Group, gives the view of a major global insurer, and describes some techniques in place today and some of the challenges confronting them.

The UK insurance industry is the largest in Europe and the third largest in the world. It employs over 320,000 people and has investments that total almost a quarter of the net worth of the UK's economy. In the 2006/2007 tax year the industry contributed £9.7bn in taxes and over the past five years the industry has paid out £40bn to cover claims on property, accidents and health.

"…insurance demonstrates an important social value, providing freedom from personal and business liabilities, security at home and work and flexibility in being better tailored to individual circumstances…"

As the recent report of the Insurance Industry Working Group[1] noted, the success of our industry stems from the value that we provide consumers and businesses on a day to day basis. This ranges from helping people and businesses to keep moving in the face of the potentially catastrophic costs of flood, fire or accident, to helping companies do business in new and dynamic fields, for example in developing sources of renewable energy. In doing so insurance demonstrates an important social value, providing freedom from personal and business liabilities, security at home and work and flexibility in being better tailored to individual circumstances. This makes social and economic life less reliant on government action.

General insurance today is not significantly different from when the industry first developed in the wake of the Great Fire of London in 1666. Back then, insurers offered to provide people with peace of mind by pooling and managing a group of individual risks, in return for a payment, or premium.

Nowadays, while consumer tastes, demands and choice have changed considerably and insurers' actuarial and risk pricing techniques have developed, this basic principle still applies. Risk is still the cornerstone of every insurer's business model.

With this in mind, RSA is proud to be partnering with Reform and the CII in developing a series of Thinkpieces entitled **"Risky Business".** Over this and the following publications, we will explore the basic concept of risk, the value that insurance adds to society, attitudes towards risk-taking and what the future holds for the UK insurance industry.

Risky Business: Insurance and Society

In this first publication we explore the basic elements of risk management, the value that it can add to people's freedom and choices and the future challenges that insurers face in taking on and assessing levels of risk.

In the modern world we are so used to the role insurance plays in managing risk that it's easy to forget the impact that it has on our lives. In order to understand the value that insurance adds to modern societies, it's worth considering what the world might look like without it:

- Families would have to live with the risk of catastrophic losses if their houses burnt down or they were burgled;
- Travellers would need to have money in the bank to cover the costs of repatriation if things went wrong;
- A comfortable retirement would be difficult for most people; and
- Business would be burdened by a range of liabilities from the risk of employee accidents to the loss of goods in transit.

Since the first commercial products were developed in the UK in the 17th Century, insurance companies have evolved more sophisticated actuarial and underwriting techniques which have allowed them to quantify, understand and price risks for various activities, both individual and commercial. Each insurer views different risks in different ways; some insurers may be prepared to take on high risks and charge an appropriate premium for this, whereas other insurers prefer a more conservative approach, taking on smaller, more manageable risks. Such a market ensures that consumers can access a variety of policies according to their individual needs.

"As social and environmental changes have generated new risks, the insurance industry has employed actuarial expertise and invested in new technology to develop a range of commercial products to cover these risks."

Insurers base their risk assessments on actuarial data that is collected through specialised and increasingly sophisticated means. Competitive pressures are driving improved risk analysis and are pushing down premium costs, creating obvious price benefits to the consumer. And as social and environmental changes have generated new risks,

[1] *Vision for the Insurance Industry in 2020*, July 2009, http://www.hm-treasury.gov.uk/press_71_09.htm

the insurance industry has employed actuarial expertise and invested in new technology to develop a range of commercial products to cover these risks.

Through the use of sophisticated techniques to monitor and assess risk, insurers are able to link the price of premiums to the probability of claims. This can help drive consumer behaviours which have a positive impact on society and helps meet policy challenges facing the Government. For example, insurance can be used to reward and support customers who adopt climate-friendly behaviour, such as premium discounts for drivers of hybrid and alternative fuelled cars. This ability to influence people's behaviour (so called "nudge-theory") and the positive impact this can have, will be examined by *Reform* later in this Thinkpiece series.

The term "risk" has developed more negative connotations in the recent economic climate, with many financial institutions being accused by the media and the public of excessive risk taking. These attitudes towards risk, particularly in a recession, will be explored in our final Thinkpiece. However, in aligning risk with such negative connotations, we're in danger of ignoring the benefits that effective risk management offers us.

What does effective risk management enable?

The development of new techniques and expertise in managing and pricing risk has had a positive impact on individual consumers. For example, as insurers have developed flood mapping tools, the level of flood risk at an individual property can be better assessed, enabling the consumer to be fully aware of any potential hazards.

Similarly the effective use of actuarial data has also allowed the development of cheap and simple travel insurance policies. Travel insurance is now widely available through a variety of providers enabling improved consumer freedom and choice at competitive prices.

Telematics technology has also been used to develop products which allow younger motorists to pay less if they drive at safer times of the day. This has enabled younger people to access insurance directly related to their driving habits and encourages them to be safer and more responsible citizens.

Similarly, insurance can encourage positive social outcomes. One example of this is a rehabilitation scheme developed by RSA Insurance Group called RSA Care, where we work directly with an injured party to ensure that they get the support and care that they need. Such a scheme encourages positive action, with experience showing us that claimants recover much quicker than when they simply receive a flat-rate compensation payment.

Such innovation in the insurance industry benefits not just the more affluent consumers. As rising living standards have allowed low income households access to a greater range of consumer goods, insurers have recognised the need for insurance to cover the increased risk of theft and loss. The risk of burglary is higher than average for people with lower incomes and the cost of replacing a television or washing machine can be significant. Insurers have been able to develop effective low cost products for these consumers by applying strong underwriting expertise and collecting premiums in more manageable ways, for example through housing associations.

"In aligning risk with such negative connotations, we're in danger of ignoring the benefits that effective risk management offers us."

Just as important as benefitting consumers, the insurance industry has helped businesses adapt to and manage changing risks. Whether through the development of products suited to micro-businesses and start ups, or those that support burgeoning industries such as renewable energy, fish farms or high-tech industries, insurance helps businesses evolve, test new models and innovate. Lower premiums due to reduced risk can incentivise safer corporate behaviour and more sustainable business practices.

Future challenges in managing risk

As insurers' risk management has developed over the last 300 years, a variety of risks are now able to be taken on board by insurers, covering everything from individuals' homes and properties, to football clubs and national landmarks. The future will hold new and different challenges for the insurance industry and it's essential that insurers are able to respond effectively. While insurers are exercised by several major issues in the current economic climate, two are of particular note.

The first such issue is climate change, which the Government now acknowledges is the greatest environmental challenge facing the world today. The Stern Review has highlighted the potentially high cost to the economy if action is not taken to combat it. The industry is aware that climate change will bring a large degree of uncertainty and insurers must adapt their business and practices accordingly. In response to this, RSA for example continue to look for innovative ways to address climate change, both in the provision of related insurance services and in the way it manages its own environmental impact.

Despite extensive research, the full impact of climate change is still unknown. However insurers must still be able to predict and model the associated risks such as extreme weather events. Both insurers and government would benefit from the availability of more accurate climate change-related data, thus underscoring the need for unprecedented levels of joint working to help businesses and consumers tackle climate change and manage its impacts. Another example is the importance of better government communication of its flood defence investment plans with insurers who need to assess flood risks for property in related areas. Without such an effective partnership, the risk posed by climate change will be difficult to assess and manage.

Another significant challenge facing society is the ageing population. Usually discussed in terms of the pensions debate, the fact that people will be living longer, more active lives also has important implications for a broader range of insurance products. For example, government regulation designed to tackle the issue of age discrimination could in fact impact other lines such as travel and motor insurance.

As we have explored, risk is the cornerstone of every insurance policy and differential pricing is key to this, with each individual paying a price related to their risk. Such a system enables a fair way of pooling risk, so that insurance can be made as widely available as possible. The recent Government Equalities Office consultation,[2] which looks at how the UK Equality Bill will apply to the provision of financial services products, does recognise the insurance industry's arguments around levels of risk related to age (namely that in motor and travel insurance age is a genuine risk factor in the calculation of risk premiums) and it does appear that insurers will be granted some form of exception, both at a UK and EU level. However, the Government appears to be in favour of enabling an exception as long as differential pricing is actuarially justifiable, something that would not work for insurers. Whereas actuarial justification is possible for many risks, for more niche markets, insurers may not have the data available to mathematically justify premiums. If legislation states that insurers must justify premium setting by reference to published actuarial data and no other means, then some insurers will choose to withdraw from the market, which would result in less competition and fewer choices for consumers of all ages. Such costs would be passed on to consumers of all ages and would surely outweigh the benefits such legislation would bring. Therefore policymakers should carefully reconsider the unintended consequences of such legislation, particularly its implications on the insurance industry's fundamental risk management processes.

"Policy makers must understand the key role that a properly functioning insurance market has on the wider economy and endeavour to preserve this."

The insurance industry has been built on the ability and appetite, to manage risk. This has provided consumers and businesses with a range of solutions with which to live and operate more freely, safe in the knowledge that insurance is able to cover any unexpected costs along the way. Although the general insurance industry has not diverted from this basic operating model in 300 years, it has, over time, developed new techniques to assess risk and has adapted to the changing environment in which our customers live. Policy makers must endeavour to understand and preserve the key role that a properly functioning insurance market plays in the wider economy. In this respect it will be crucial for the industry to work constructively with policy makers to create and foster a more balanced legislative environment to the benefit of society as a whole.

If you have any questions or comments about this publication, and/or would like to be added to a mailing list to receive new Thinkpieces by email, please contact the CII Policy & Public Affairs team by email: thinkpiece@cii.co.uk or ☎ 020 7417 4783.

Forthcoming articles in the* Risky Business Series *include:

- ***"Insurance and Nudge Theory," by Elizabeth Truss and Nick Bosanquet,* Reform**
- ***"Risk and Insurance: A Critical Perspective," by Jonathan Swift, Editor of* Post Magazine**
- ***"Rethinking Risk," by Clare Sheikh, RSA Insurance Group***

For more information, see www.cii.co.uk/thinkpiece

[2] http://www.equalities.gov.uk/news/age_consultation.aspx

Andy Haste has been Group Chief Executive of RSA Insurance Group since April 2003. He was appointed non-executive director of ITV plc in August 2008. Andy's previous roles include Chief Executive of AXA Sun Life plc and director of AXA UK plc. He is the former President and Chief Executive Officer of Global Consumer Finance Europe at GE Capital UK, Western Europe and Eastern Europe, and is the former President of National Westminster Bank's US Consumer Credit Business.

With an almost 300-year heritage, **RSA Insurance Group plc** is one of the world's leading multinational quoted insurance firms. It has the capability to write business in over 130 countries, with major operations in the UK, Scandinavia, Canada, Ireland, Central and Eastern Europe, Asia and the Middle East and Latin America. Focusing on general insurance, it has almost 22,000 employees and, in 2008, its net written premiums were £6.5bn. *For more information, please visit www.rsagroup.com*

Reform is an independent, charitable, non-party think tank whose mission is to set out a better way to deliver public services and economic prosperity. Our aim is to produce research of outstanding quality and to communicate it to politicians and opinion formers in all parties and none in order to create a consensus for reform. *For more information, please visit www.reform.co.uk*

As the leading professional body for the insurance and financial services sector with over 93,000 members in more than 150 countries, the **CII Group** is committed to protecting the public interest by guiding practitioners in the sector towards higher technical and ethical standards. We do this by offering them a broad portfolio of services and support to achieve this, including membership, qualifications, continuing professional development, thought-leadership, lobbying and the maintenance of a benchmark Code of Ethics. *For more on the CII and the **think**piece series, please visit www.cii.co.uk/thinkpiece*