Consultation of draft Issues Paper on customers receiving value from insurance products

Survey response 1

Please provide your information:
Name: - Amali Seneviratne E-mail address: - amali.seneviratne@actuaries.org Name of jurisdiction: - International Name of organisation: - International Actuarial Association (IAA)

Do you agree with your responses being made public on the IAIS website?
Yes

General comments on the Issues Paper on customers receiving value from insurance products

General comments on the Issues Paper
The IAA welcomes the Issues Paper, as it provides examples of good practices in the supervision of value for money and also sets expectations for supervisory authorities. However, IAA notes that the division of responsibilities among different bodies — such as supervisory authorities, consumer protection agencies, Financial Ombudsman Bureaus, and courts — limits the powers of supervisory authorities. IAA also notes that individual legal frameworks may restrict the ability of supervisory authorities to take action against insurance companies. While specific insurance contract acts or similar provisions provide important protections for policyholders, they may also limit the extent to which insurance supervisors can interpret insurance policies. The IAA has noted that the examples given from different countries overlap and could be edited. The IAA has focussed on issues not yet included in the paper. We note that competition plays a significant role in price formation. In closed markets, competition does not function, and insurance prices may therefore be high. On the other hand, particularly in the case of IBIPs (Investment Based Insurance Products), insurance companies compete, for example, with banks and investment funds. There are some examples on competition issues in Paragraph 8. The issues paper does not address the question of bonus distribution which we have commented in Paragraph 8.

Comments section-by-section

Comments on the Executive Summary
A factor that makes it challenging for consumers to evaluate value is the difficulty of comparing offers from different companies. The issues paper lists conflicts of interest in distribution as factors that diminish value for customers. However, other conflicts of interest may also affect value, as discussed in Chapter 4.4. Factors that enhance the value for customers are also: ·The level of service provided by the insurance product. For some products, a major value (if not the principal value) of the policy is the service provided in addition to the coverage of claims. For example, in a boiler & machinery policy, it is the inspection service that tries to prevent a boiler breakdown that is the most important part of the policy, and not the claim coverage in the event of such a breakdown. Other products where the service is a major part of the policy includes: o Evaluation of the strength of cyber risk protections in an employer's computer systems as part of the underwriting for cyber insurance policies. (This is becoming a major part of cyber insurance underwriting, and a major part of high quality cyber policies.) o Litigation defence services for professional liability policies, including those for medical professions, accountants, insurance agents and other professionals. Note that for such coverages provided in litigation-intensive jurisdictions, protection of the insured's reputation via vigorous litigation defence may be far more valuable than an eagerness to pay any claim that is presented. The over-willingness to pay any claim presented can lead to the encouragement of fraudulent claims, and hence higher expense and damaged reputation for the insured. oLoss control services provided for commercial risks for both first party coverages and third-party coverages. oWhile price may be the predominant source of perceived "value" for personal lines policies, the service feature can be a major (if not the major) component of insurance policies for commercial in terests. In some markets, the service component is also a major factor for personal lines, as witnessed by a focus on publicised "complaint ratios" for personal lines products. Note also that for higher income non-commercial policyholders, the service component can be more important that price. ·Competition of insurance companies typically enhances the value of insurance policies. ·Benefits that are not directly linked to an insurance policy, such as tax reliefs, although the sales of the product should not be based on factors that may be amended in the future.

General comments on section 1 Introduction

Comments on section 1.1 The positive impact of insurance

Comments on section 1.2 Low value and trust can deter customers from buying insurance

Comments on section 2 Challenges for consumers to evaluate value when buying insurance
This section ignores the varying levels of service that may exist among the insured's choices when looking for a suitable insurance policy. While the paper points out the publication of complaint ratios by some supervisors, this is only a part of the picture in evaluating the relative service levels among products and insurance providers. This is particularly important for several reasons, including: ·While every insured experiences the pricing levels that exist for a policy, they only experience the claim service level when they have a claim, and such claim events may be very infrequent. As such, they are more in need of other sources (rather than personal experience) to evaluate service levels. ·Information on relative service levels may be available via various sources on the internet, but individual customers may not be aware of such sources. As such, it may be helpful to provide information on the existence of such sources. We note that Paragraphs 25 and 26 address discounts, which are also discussed in section 4.2, Pricing issues. We recommend that these topics be mentioned in section 4.2 as well, in order to present all relevant pricing matters within the same chapter. We also note that there are other situations in which it is difficult for customers to assess the value of a policy: ·Discounts are granted only for the first policy year(s), and especially when changes in health conditions may prevent the customer from purchasing a new insurance policy. ·The prices increase as the insured person ages, and this is not clearly communicated. ·Different companies apply different reference prices (for example, a company may use outdated mortality assumptions).

General comments on section 3 A spectrum of supervisory approaches to address value

Comments on section 3.1 Explicit supervisory expectations that insurance products provide value
In some jurisdictions there are explicit supervisory expectations that apply to certain insurance policies. For example, in Finland, there is a concept known as the "reasonableness principle," which applies to statutory insurance policies — e.g., motor liability insurance. Their premiums must be in a reasonable proportion to the capital value of the expected costs arising from the insurance. Regarding the reasonableness principle, the assumption has been that the effects of limited competition are mitigated through transparency, and the supervisory authority regularly publishes information on the claim ratios of different companies. The issues paper does not address the question of bonus distribution, even though it is essential from the perspective of customer value. Many jurisdictions have provisions in place that guarantee some return of profits to policyholders. If product prices are high, this may later be compensated to policyholders through the distribution of bonuses. This is not always the case for unit linked products. However, for example in Germany, surplus distribution also applies to unit linked products, but only to the part that is not linked to units. It is worth noting that the question of bonus distribution is typically more relevant in shareholder-owned companies than in mutual companies, where the policyholders own the company. Depending on the jurisdiction, bonus distribution may be rule based or principle based. For example, in Germany, under the Act on Insurance Company Supervision, 90% of the surplus (particularly for with profits products) must be allocated to policyholders. In Finland, under the Act on Insurance Companies, insurers must comply with the so called "equality principle," which concerns the additional benefits of with profits products and the distribution of surplus, both among customers and between customers and the company's shareholders. See also the example from the UK (paragraph 32 in the issues paper) It is, at least in principle, easier to supervisory rules- based bonus distribution. However, a question remains as to how expenses are allocated across different product lines. The insurance industry in Finland originally recommended a principle based model on the grounds that, in a rule based model, companies that make a profit are required to distribute a significant share of the surplus, whereas a deficit directly reduces the amount of own funds. To avoid losses, companies could therefore invest in risk free assets. In a principle based model, in theory customers should instead receive a better return. Supervising a principle based model is difficult, as developments in Finland, for example, have shown. The assumption was that competition would set bonus levels at a reasonable level, and companies were required to define their bonus policies in advance. However, all companies ended up with the same objective — at least a risk free interest rate would be distributed to the policies. As companies gradually discontinued the sale of with profits products, competition disappeared and the with profits portfolios went into run off. As a result, some companies distributed only the risk free return, and policyholders did not receive returns higher than the risk free rate objective defined by the companies. The Financial Supervisory Authority in Finland therefore issued a statement that equality must be assessed not only on the basis of the companies' predefined objectives but also at each point in time, taking into account the prevailing profit development and the company's solvency.

Comments on section 3.2 Other requirements that enable supervisory action on low-value products

Comments on section 3.3 Modifying the insurance purchase decision-making environment
In some jurisdictions, consumer protection laws strengthen consumers' rights and require that an insurance policy becomes effective only once the consumer has provided written consent. It is generally good practice to require comparable information from different market players. For example, the Key Information Document (KID) is required in many jurisdictions when insurance based investment products are sold. A typical KID includes a product overview, main risks, costs and fees, potential returns or benefits, term and cancellation conditions, and an explanation of the complaints process. The IAA notes that comparisons, including KID, often include information that is subject to the judgement of the insurance company. The Issues Paper describes, for example, the Hong Kong fulfilment ratio disclosure requirement as a useful indicator of value for money. IAA states that this framing may overstate the tool's utility. The ratio measures whether the insurer has delivered against its own point-of-sale illustration; it does not address whether the illustration assumptions were realistic, whether total returns are competitive, or whether bonuses are distributed equitably across policy generations within a participating fund. A high fulfilment ratio is compatible with low absolute returns and with inter-generational inequity. This connects to the bonus distribution point raised in Q8. The Issues Paper should qualify the presentation of fulfilment ratios accordingly. In addition to the KID, for example, in Finland, the Financial Supervisory Authority, in its regulations and guidelines on "Disclosure of expenses and returns of long term savings agreements and insurance policies," has defined not only the types of expenses that must be taken into account when providing an offer to a customer, but also that the offer must be calculated both assuming a zero discount rate (or another discount rate specified in the policy, if applicable) and a justified and realistic expected return. The zero return information enables customers to compare different insurance companies. The regulation also specifies that the illustrations must be prepared without taking taxation into account. The calculations may only take into account such discounts granted to the customer that are binding on the supervised entity.

Comments on section 3.4 Consumer education and information

General comments on section 4 Aspects that can diminish the value offered by insurance
We note that this section could mention that poor service levels may be a factor in diminished value.

Comments on section 4.1 Needs-benefits misalignment

Comments on section 4.2 Pricing issues
While the topic of “margin personalisation” (called price optimization in the U.S.) deserves mention in such a paper, the reference to the experience in Netherlands can lead to the wrong interpretation in some situations. For many property/casualty products, the least is known about a customer when they are first insured. As time goes on, via subsequent renewals, an insurer can price and underwrite a given insured more accurately as they learn more about the insured. Ideally this will lead to lower prices for the better risks, rather than higher prices based on the likelihood of the insured shopping their policy. But this doesn’t impact the problem of obtaining new insureds for which less information is known. Some insurers have called this phenomenon the “new business penalty”, as the insurer may have to offer a rate lower than the lack of information can justify. So having a higher profit on renewal policies is sometimes just the consequence of this “new business penalty” for obtaining new accounts. We recommend that a comparison of profit on new versus renewal policies needs to be researched further where it exists, rather than presuming without research that it is a sign of “margin personalization”. The paper should also make more mention of a pricing issue particularly relevant to home property insurance. That issue is the selling of a proper amount of insured value. Some insurers can quote a lower price by selling less coverage via a lower amount of insured value, for example by selling a policy with $300,000 in the event of a total loss when the cost to rebuild may be $400,000 or more. The insured may end up looking only at the price when compared to competing offers, but if a total loss occurs, they may end up with not enough funds to rebuild.

Comments on section 4.3 Bundled or tied sales

Comments on section 4.4 Commissions and other distribution conflicts of interest
The aim of the Section is to describe conflicts of interest, and it focuses mainly on product distribution. However, it does not address the management of the policies. The Section also does not address conflicts of interest in financial conglomerates. This is particularly relevant for IBIP (Investment Based Insurance Products) products, where policyholders bear the investment risks, as such conflicts may affect the value of the policies, for example: ·the use of funds with high commissions ·the termination of low commission funds and their replacement with higher-commission funds ·the transfer of low value or risky investments from other entities within the group ·undue portfolio turnover that increases the expenses of the funds and increases the profits of other entities. Conflicts of interest may also arise in funds managed by the insurance company. For example, the company may transfer low value investments to the funds in order to improve its own financial position.

Comments on section 4.5 Complex decisions expected of the customer
The Issues Paper addresses switching decisions (paragraphs 58–61) but not the complex in-force decisions consumers face during the life of long-term products. These include surrender-versus-persistence decisions in participating policies, where the interaction of guaranteed cash value, non-guaranteed bonuses, long break-even horizons and surrender penalties is difficult for consumers to evaluate; and ongoing fund selection in unit-linked products, where consumers make repeated investment decisions typically without ongoing advice after the point of sale. Both can materially diminish realised value even where the product was appropriately sold. Especially the above mentioned issue related to repeated investment decisions is also linked to the distribution conflicts of interest discussed in Paragraph 8.

General comments on section 5 Aspects that can enhance the value offered by insurance

Comments on section 5.1 Product design that rewards risk reduction

Comments on section 5.2 Customer-centric claims handling
The discussion of parametric insurance makes no mention of basis risk. Parametric insurance has some very beneficial aspects for certain customers, and some very troubling aspects for others (namely the existence of basis risk that may not be tolerable for some potential customers). Recommend including some mention of both the advantages and disadvantages of this product design, even if only via a footnote reference to a different paper

Comments on section 5.3 Product flexibility and responsiveness

Comments on section 5.4 Downside protection
Downside protection should also address the risk of early-years lapse in long-term life products, which typically imposes the largest economic loss on the consumer. Relevant supervisory tools include cooling-off periods calibrated to product complexity and use of early lapse rates as a trigger for supervisory review of sales practices.

General comments on section 6 How supervisors can assess that the insurance industry is offering value

Comments on section 6.1 Demonstrations in the governance and corporate culture

Comments on section 6.2 Low claims ratios
A focus on low claims ratios may overlook two areas where they can be misleading. These include: ·Policies where the primary benefit from the product is the service level associated with the product. This is mentioned earlier in our comments with regard to the Executive Summary. Such valuable services (that can lead to high expense ratios but low claims ratios) can include loss control and inspection services, and litigation defense services. ·Policies that cover very infrequent but very large claim events, in particular a coverage focusing on major disasters such as earthquakes and wildfires. For such policies, the value does not come from a high claims ratio for most years, but from a high degree of capital backing the policy (such that the insurer can actually pay the resulting claims without going insolvent).

Comments on section 6.3 Other claims handling indicators

Comments on section 6.4 Investment return compared to profit
We recommend that the comparison be made to the profit without dividends as follows: ”When appraising the value of investment-based insurance products, the investment return to the customer compared with the profit without dividends made by the issuer is a clear signal of whether the product is providing value to the customer.”

Comments on section 6.5 Undue costs and commissions for pure risk products

Comments on section 7 Conclusion