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The pricing of payment protection insurance (PPI) is a hot topic right now given the attention the Competition Commission is paying to this area as part of its ongoing market inquiry.

In its statement of issues published in April this year, the Competition Commission made it clear that it will be looking to establish whether there is evidence of rigorous price competition amongst retail suppliers of PPI. For example, are prices set at competitive levels and what is the rationale for any such pricing diversity? The latter is likely to include non-price aspects such as product characteristics and service quality at the point-of-sale.

Whilst the Competition Commission investigation has once again raised the issue of pricing within the industry, the inquiry itself will focus on the premium charged to the customer rather than how insurers rate and price the product itself. However, the current spotlight on PPI provides an opportunity for the industry to explore an element of pricing that should not be ignored: is it treating consumers as a single homogenous group?

So, should the industry be moving to a more risk-related pricing structure which, some might argue, provides more emphasis on Treating Customers Fairly (TCF)?

I think it is important to make clear that I am not talking about PPI moving to a fully underwritten product as is common in the life insurance market. Risk based pricing uses certain characteristics of the insured, such as age and gender, to rate the risk therefore setting a more appropriate price for the individual – in effect, creating smaller pools of risk rather than one big one. The impact on the sales process is minimal. It is simply a matter of adding in a few simple questions to identify these characteristics, not asking customers to fill out a 10-page proposal form complete with details of their full medical history and supporting evidence if necessary.

Consumers want a simple product that meets their needs at an affordable price and distributors want a straightforward sales process so that they can ensure a compliant sale. Can the industry deliver?

Before looking ahead to how the industry could move forward, I think it appropriate to take a brief look back at the recent history of PPI. Certainly the idea of rating relative to risk is not a new concept. A number of insurers have, in the past, tried to go down this path only to find that these risk based schemes have resulted in varying levels of success.

I believe that the sales process itself was a significant contributory factor to any previous lack of success. Third party distribution was the dominant sales channel: clients determined what the product should look like and how it should be sold to the customer and insurers were dependent on the major

lenders as their main channel of distribution. The market wanted a one-size-fits-all rate that it could publish on a leaflet to hand to a customer in the branch. Insurers saw their margins gradually being squeezed so, in order to offer a competitive price and yet operate a profitable book of business, were driven to adopt a homogenous approach and 'light' administrative structures using summarised data that was simple to manage. Risk based pricing simply wasn't appropriate at the time given the nature of the marketplace.

So where do we stand today? It's a very different marketplace and there are a number of external factors that are now influencing the look and feel of PPI as well as how it can be sold to the customer.

We have seen the emergence of Internet-based standalone providers who have seemingly been the early adopters of more flexible products at a more affordable price. While their market share is still relatively low, they have attracted a lot of positive attention from the personal finance writers on the national newspapers. These providers also rank highly on the aggregator sites, which appear to have gained the trust of consumers. While they don't control the distribution of the product, I would argue that they control the 'hearts and minds' of the consumers and the influence of the likes of moneysupermarket.com on their decision to buy cannot be ignored. Mortgage brokers and intermediaries have also emerged over recent years as having a significant influence in the distribution of PPI. Those regulated to conduct advice-based sales are already used to managing life insurance products and pensions, so introducing a risk based approach to PPI would already be a familiar concept to them.

The market investigation conducted by the Office of Fair Trading (OFT) and the resulting inquiry by the Competition Commission could have dramatic consequences for the industry both in terms of the price passed on to the customer and how the customer accesses the product in the first place. Perhaps more importantly, the TCF initiative driven by the Financial Services Authority (FSA) has highlighted the need for insurers to review what customer data is required so that the customer lies at the heart of product design and the sales and claims processes. Does this increased focus on understanding consumer needs and buying preferences mean that there is a greater willingness by the industry to consider the benefits of a risk based pricing approach?

Understanding the customer and gathering data are, in my view, the two crucial factors to get right if such an approach is to be successfully adopted.

Looking at the risk itself, much of the personalised information needed to assess each individual risk such as age and occupation is actually gathered as part of the loan or mortgage application process and has been since PPI was first introduced to the UK in the 1970s. In recent times stand alone providers have become no strangers to asking these questions. There are those who argue that it is impossible to obtain enough information about an applicant's future life plans to be able to assess a risk over a three to five year period. I would argue that this is what insurance is all about – assessing an expected future claim based on the data that has been collected about an individual.

Sadly, the IT legacy issues that the industry has faced – and continues to be challenged by in some circumstances – have hampered its ability to build a full picture of the past thirty years. Detailed claims history has therefore not always been available.

To create a tailored product that is flexible enough to suit individual circumstances additional risk factors such as age, gender and occupation type should be considered. These features will help insurers better understand the true risk profile of each portfolio and their impact on the expected cost of claims.

The composite insurers in the motor market faced the question of risk based pricing a number of years ago, when they were heavily reliant on brokers as their main distribution channel. Direct Line broke the mould in the late 1980s, cutting out the broker and adopting a price-led proposition to acquire market share in the private motor sector – and in doing so, increased the number of data points it collected for each customer. This in turn increased its knowledge bank of its customer base and so enabled the business to develop its motor product range and ratings. Today, Direct Line sells a wide range of general and life insurance products as well as extending its offering into loans and mortgages – and the red telephone and red mouse have arguably become the most recognised insurance brand amongst consumers.

If risk based pricing is the right direction for the industry to follow, how should it go about taking the first steps along the path? It doesn't require a headlong rush, rather a step-by-step practical approach. For example, insurers could start collecting additional data on customers before actually using it. This would allow them to build their knowledge of individual characteristics and find the balance of asking the right amount of questions without having a negative impact on the sales process. It is always possible, of course, to create different products for different sales channels – for example, introducing a new age and gender based PPI product via mortgage intermediaries who are used to the advised sales process. Keeping it simple will be the key to success – the more complex the rating criteria, the more assumptions have to be made, and the more opportunities therefore for error to occur.

While the assumptions may not be wholly accurate, if the credibility of the data used is robust then insurers can create a good picture of the risk they are facing.

Once the decision has been made to apply a risk based pricing approach the practical implementation challenges need to be addressed. For example how would the industry manage the transferral of customer data from one system to another to avoid advisors asking the same questions several times during the sales process, given that it is more likely the customer will purchase mortgage payment protection, for example, at the same time as arranging their mortgage?

Gone are the days when brokers had to leaf through the pages of a rating manual but even so, the challenge of introducing new rating criteria onto legacy systems has proved a difficult issue for some providers to overcome. However, technology is critical to an insurer's capability of introducing risk based pricing. It can hide the complexity of the rating engine in the background, while providing the distributor of the product with an easy to use and compliant sales tool. The technology is there to be exploited; however the issue that many major organisations face is how to get their particular requirement high enough up on the IT priority list to command the board's attention.

The cost of change is potentially one of the biggest hurdles to overcome. As I've already touched on, a huge amount of data has been built up by insurers and distributors over the years – but unless the benefits outweigh the cost, what is the incentive to change?

So what might happen to PPI sales which are not tied to a lender if an insurer chooses not to introduce risk based pricing at the same time as the rest of the market? Let's assume that products sold via this insurer have a flat rating structure and the competition has introduced a single rating factor such as age, the commission levels are assumed to be similar. The retail rates charged to older customers for the flat rated product will be cheaper than the market rates and conversely a more expensive rate will be calculated for younger customers on the flat rate. The flat rate insurer will need to acquire a predetermined proportion of customers from the younger age band in order to achieve its desired level of profitability. If customers are comparing prices charged or if an Internet aggregation site is used, then the flat rated insurer will obtain less younger customers and more older customers than planned and hence the profitability will be less than budgeted.

It is possible that the increased understanding of risk that would result from adopting risk based pricing will actually assist insurers in the management of their internal capital models, and so help to meet requirements for Solvency II. Instead of setting an ROE target on one particular grouping, insurers should look to achieve profitability across a variety of risk pools – perhaps establishing distinctive brands targeting specific groups – to improve the management of the account as a whole.

I firmly believe that adopting a risk based pricing approach and gradually building in new rating criteria will allow insurers to create insurance products that deliver the protection consumers need not just today but in the future. Combining our years of experience and data with technology and building our knowledge of our customers will create an offering that is simple for both consumers to understand and distributors to sell. And that, surely, is the end-game for us all?

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