

VOORBURG 2001

**SESSION 2: MINI PRESENTATIONS ON
PRODUCER PRICE INDICES**

**CHALLENGES IN THE DEVELOPMENT OF A PRICE INDEX FOR
INSURANCE SERVICES IN THE UK**

Bill Fear and Nick Palmer
UK Office for National Statistics

CHALLENGES IN THE DEVELOPMENT OF A PRICE INDEX FOR INSURANCE SERVICES IN THE UK

Introduction

An element of the Office for National Statistics (ONS) project to develop Corporate Services Price Indices (CSPIs) is to develop a price index for corporate insurance services in the domestic UK market. That is, prices for insurance underwritten in the UK for UK policy holders. The focus is on non-life insurance only.

Initial attempts by the ONS to develop an insurance services price index encountered several difficulties. These were partly caused by insufficient understanding of the complexities of the industry in the UK and difficulties in determining the most appropriate pricing methodology.

It also became apparent that there were a large number of industrial and professional bodies that had a potential role to play in the development and consultative process. It has been a challenge for the ONS to: identify all these organisations; to understand their inter-relationships; to understand their views on prices; and to establish a way in which the ONS could operate among them in an even-handed way as part of a positive consultative process.

This paper will focus first on the initial approach and the difficulties associated with it, then on the approach now being undertaken to develop the index.

Initial approach

Initial efforts (in 1999) at developing this index concentrated primarily on identifying the components or products that make up the insurance services industry and on establishing links with trade associations and the insurance companies themselves.

Building a framework

The challenge was to understand the full range of services, or lines of insurance, and which insurance companies were providing them. This would build a suitable framework for developing pricing mechanisms

Detailed structures were produced for most lines of insurance and the conclusion at that stage was that it would be impossible to collect viable prices for all of the items, and even selecting a representative basket of items was a substantial task.

What things should prices be collected for ?

A problem has been to identify suitable 'baskets of standard risks' and to define them clearly. It was also not clear exactly what prices would be collected for standard risks nor how, nor by whom, they would be priced on a quarterly basis.

Standard risks are categories of risk associated with different components of insurance. For example, the model, make and year of a car categorises the car as a

standard risk which is then priced. This price is then further adjusted according to postcode, previous claims, and so on. Frozen policies can be created by selecting a real policy at random from the insurer's or broker's book and freezing the main characteristics of the policy. The policy is then priced on an annual basis as either new business or as a renewal. (So another challenge is to establish the right mixture of new business and renewals.) Also, components subject to changes in value should be escalated in line with appropriate indices – the choice of these being another challenge.

The development of a suitable basket of standard risks was dependent on the continuous support of trade associations and insurance companies and the maintenance of regular, informed dialogue. Changes of personnel, both within the ONS and the insurance companies and bodies hampered this work and it was decided to pursue a more inclusive approach with broader consultative support (a challenge in itself).

Current approach

In order to progress with the insurance index further consultation has been entered into with a wider range of parties. Firstly, additional relevant industry bodies were identified. In addition to the trade association representing the insurance companies (the Association of British Insurers - ABI), these included actuaries (Institute of Actuaries - IoA), insurance brokers (British Insurance Brokers Association - BIBA), and an association representing insurance risk managers (AIRMIC). All these bodies were contacted with a brief synopsis of the project and were engaged in the consultative process. A full list of existing participants is given in the appendix.

Roles in the consultative process

After agreeing to participate, the various bodies' roles need to be defined and understood to enable the consultative process to be effective. Clarifying all these and how they inter-relate is an immediate challenge for the ONS.

All participants may contribute to any part of the development process but particular aspects may be suited to specific bodies. For example, it is envisaged that the actuaries will be able to identify standard risks and contribute to the pricing methodology. Also, the brokers and insurance companies are particularly important to the identification of appropriate pricing mechanisms. As insurance premiums are heavily influenced by level and degree of risk management by the insured, AIRMIC is in a prime position to contribute to the development of quality adjustment protocols and provide the bridge between the insurers and insured.

How should prices charged through brokers be treated - if at all ?

The issue of whether to collect prices from insurance companies (as producers), from brokers or from both needs to be resolved. Around 90-95% of the value of UK non-life insurance takes place through brokers in the UK. This will be a key topic of the consultative process – and it relates to balancing statistical requirements with the needs and interests of the industry itself. For example, in the case of the broker does

the price of insurance include their fee - or does the broker's fee relate to a separate service altogether which should be excluded from this price index ?

Cases such as this may also need to be dealt with: a broker may quote a price, say 100 units, but obtain the cover for a cheaper price, say 80 units, but still charges the insured 100 units for the cover.

Development of a pricing mechanism

The method of pricing standard risks and make use of 'frozen policies' is to be explored further. Regular consultation would be required to account for quality adjustments and changes in specification. For example, when an insurer no longer covers the type of business in the policy; or when the nature of the market has changed such that the combination of standard risks no longer applies; or when a particular line is being re-evaluated by the market, leading to price changes.

Also should the return to the insurance company from the invested portion of premiums to be taken into account individually per line of insurance, or even per policy ? Or can a simple deposit base rate be used, or a standard investment index ? And what balance should be drawn between new business and renewals.

Other considerations which should be taken account of

Insurance is one of the biggest financial markets, is one of the top three financial industries in the City of London, and in the UK is self-regulating. Insurance pricing in the UK is market regulated by the underwriters and the actuarial standard risks form a baseline. It also has some unique features which may need to be taken account of, for example, the special status of Lloyd's of London (an incorporated society of private insurers) and the "London Market" (an international wholesale insurance market and the main centre for world reinsurance business).

A UK insurance services price index could have significant implications for the industry and it needs to be fully understood what these are. Also the price index methodology needs to be acceptable to the industry.

Realistic aims

A balance needs to be made between the complexity of the industry and what is actually needed, and achievable, to create a valid index. For example, should reinsurance be excluded and treated separately ? Or does self insurance via 'captives' need to be taken account of (unlikely – the captive is owned by the parent company and serves only the parent company and it does not trade on the market) ?

Relationship to other CSPIs

Costs of insurance services are often a factor in a number of other CSPIs, such as freight transport and air fares. When developing an insurance services index its relationship with, and influence on, other CSPIs needs to be understood and reflected appropriately. This would support credibility.

Compatibility with UK National Accounts

For national accounts, existing output indicators are based on net premium incomes and these are deflated by indices derived from: consumer price indices for household goods; data on consumers' expenditure on insurance; and indices of construction costs. An understanding of how the proposed approach to a CSPI for insurance services relates to this existing national accounts method needs to be developed, with any compatibility maximised.

Appendix

Current Participants in the consultative process:

Association of British Insurers (ABI)

Institute of Actuaries (IoA)

Association of Insurance and Risk Managers (AIRMIC)

British Insurance Brokers Association (BIBA)

Lloyds of London (Department of Marketing and Solvency)

International Underwriting Association (IUA)

Potential participants:

General Insurance Standards Council (GISC)

Financial Services Authority (FSA)

Chartered Institute of Loss Adjusters (CILA)

Chartered Insurance Institute (CII)