Pricing practices in the retail general insurance sector: Household insurance

Thematic Review

TR18/4

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Contents

How to navigate this document onscreen

returns you to the contents list

takes you to helpful abbreviations

1 Executive summary

Overview

1.1 Insurance serves an important social need and is a key financial product underpinning a well-functioning economy. The UK retail general insurance (GI) market has seen price competition for many years which has been heightened by the emergence[1] and growth of price comparison websites ('PCWs') for personal lines business. When deciding which product to buy, the increasing use of PCWs often leads to consumers choosing their insurance provider solely or primarily based on price.

1.2 Price competition is especially apparent for motor insurance where PCW use has been higher than other personal GI business lines and for which industry level data[2] shows a lack of overall underwriting profitability for the market. In contrast, home insurance has generally been profitable at an industry level over the last 20 years. This is due to the combination of longer average tenure of home insurance policies and a relatively low frequency of UK catastrophes.

1.3 However, despite the outward appearance of a price competitive market, the way firms price personal lines GI products has increasingly come under scrutiny. Concerns primarily (but not solely) stem from the practice of price differentiation, how this is carried out by firms and its potential impact on consumers. Price differentiation is the practice of varying the prices charged for an equivalent product to different consumers with the same or very similar risk characteristics and cost to serve (also referred to as 'differential pricing' or 'dual pricing'). This leads to variation in the margin and the profits or losses made by firms, for different cohorts of consumers buying the same product. For example, by charging higher prices to renewal consumers (back book) than to new consumers (front book) with the same risk characteristics and costs to serve.

1.4 Concerns around price differentiation have grown as firms have been able to obtain ever increasing amounts of data about their customers. This often includes behavioural characteristic information as well as the details of the risk being insured. This has raised questions about the risks of exclusion and discrimination. These concerns have been raised by many stakeholders, most recently via the Citizens Advice' super-complaint, as well as within the media.[3] Issues around price differentiation have also been highlighted in work done by the FCA, as discussed below.

1 The first car insurance comparison website established in 2001.
2 Source – the Association of British Insurers (ABI).
3 These stakeholders include the Treasury Select Committee, Financial Ombudsman Service, MPs, Ministry of Justice (MoJ), Equality and Human Rights Commission (EHRC) and consumer groups. For example:
- The Financial Ombudsman Service published in its April 2018 news issue 144, an article "Paying the Price?" In this article, the Ombudsman provided some examples of insurance pricing complaints and set out its approach to dealing with these issues fairly - Ombudsman News Issue 144 April 2018
- The Government's Consumer Green Paper highlighted that there is a large gap between the best and worst deals received by consumers, with the vulnerable often suffering disproportionately. Department for Business, Energy & Industrial Strategy. Modernising Consumer Markets - Consumer Green Paper April 2018.
- Citizens Advice super-complaint lodged with the Competition and Markets Authority (CMA) September 2018.

Background

1.5 In 2016, we published 3 papers (OP22, PS16/21, FS16/5) that raised concerns around GI firms' pricing practices. We noted that in certain circumstances, pricing practices may lead to consumer harm. In particular, the Feedback Statement (FS16/5) published following the Call for Inputs on Big Data, raised concerns about the potential impact of insurance pricing which did not reflect a consumer's risk and cost to serve. In this FS, we proposed a piece of diagnostic work to look at pricing practices in a limited number of retail GI firms.

1.6 Subsequently, we made a commitment in our 2017/18 Business Plan to undertake diagnostic work on GI pricing practices. The aims were to significantly enhance our knowledge of how retail general insurance firms' pricing approaches and rating factors work in practice, and to assess the governance and controls firms have implemented around pricing. This paper summarises the scope and finding of that work and the next steps. In performing this work, we have also sought to understand the drivers and the types of systems and data firms used to decide the final price offered to consumers and whether firms' pricing practices have the potential to cause material harm to consumers.

1.7 This paper should be read with the other documents published today, "General insurance pricing practices Market Study – terms of reference" and "Fair pricing in financial services – Discussion Paper".

Scope and methodology

1.8 We decided to focus our work on home insurance as we believed it would provide the best example of the range of consumer outcomes arising from current pricing practices, particularly for renewals, dual pricing and consumer inertia. These features have consistently been the key areas of public, political and media concern regarding pricing.

1.9 We included a sample of 18 firms in our review. This enabled us to consider a broadly representative sample of insurers and intermediaries with different types of business models, to understand the different approaches and practices operating in the sector.

1.10 The diagnostic work undertaken included review of:

- firms' pricing strategies, governance and controls
- firms' pricing approaches (the methodology used to set the price)
- the types of systems and data used
- rating factors used in pricing
- scenario analysis to understand the extent to which the prices consumers pay are above or below the risk premium and the cost to serve including the impact on price due to consumer tenure and distribution method

Broad theory of harm

1.11 In our Mission Statement we set out the FCA's decision-making framework. The work we have undertaken on pricing practices is diagnostic work and falls under 'Stage 1 – Identification of harm, potential harm or markets not working as well as they could'.

1.12 In this review, our broad theory of harm was that some consumers (notably those who are vulnerable or less able to shop around) may pay significantly more than the costs of providing them with insurance cover, over time. In some instances, this could result in harm or be an indicator of potential harm to these consumers.

1.13 As this was Stage 1 diagnostic work, we had not committed to reporting our findings at the outset of the work. However, we have found a range of potential issues meriting further investigation. So, we believe it is appropriate to set out our concerns in this report and to reiterate our existing expectations of firms in relation to pricing while we continue our work in this area.

What we found

1.14 We identified the following issues relating to firms' current pricing practices that present the most potential for significant harm and poor outcomes for consumers:

- Firms failing to have appropriate and effective strategies, governance, control and oversight of their pricing practices and activities, such that they are unable to reliably assess and evidence whether they are treating their customers fairly.
- Differential pricing leading to some identifiable groups of consumers paying significantly higher prices than other identifiable groups of consumers with similar risk and cost to serve characteristics.
- The risk of discriminating against consumers through using rating factors in pricing based (directly or indirectly) on data (including third party data) relating to or derived from protected characteristics.

Our expectations of firms

1.15 We regard pricing as one of the most significant business activities, for general insurers and for those intermediaries undertaking this activity, with the potential to cause significant harm to consumers. We expect all firms to comply with FCA rules in overseeing and carrying out pricing activities. This should be in line with the Principles for Businesses (PRIN), Code of Conduct (COCON), Statements of Principle and Code of Practice for Approved Persons (APER), Insurance Conduct of Business Sourcebook (ICOBS), Product Intervention and Product Governance Sourcebook(PROD) and Senior Management Arrangements, Systems and Controls (SYSC) in our Handbook[4]. In particular, this includes paying due regard to the interest of customers and treating them fairly, when they purchase or renew their general insurance products. These are fundamental obligations with which authorised firms must comply.

4 Principles for Businesses 1, 2, 3, 6, 7, and 8; COCON, APER, ICOBS, PROD 4; SYSC 2; SYSC 3; SYSC 4; SYSC 14.

1.16 We expect all firms to take reasonable care to establish and maintain such systems and controls as are appropriate to their business. This includes considering their pricing activities and whether the governance, systems and controls over these activities are appropriate and sufficient to ensure fair treatment of their customers. For these systems and controls to be appropriate and sufficient, we expect that adequate management information is generated and analysis performed to enable senior management to reliably assess the impact of their pricing practices and decisions upon their customers.

Next steps

1.17 We are concerned that general insurance pricing practices have the potential to cause harm to consumers, particularly those who are vulnerable. We will address this by taking these approaches:

- We will use our supervisory powers to require firms to tackle evidence of harm and expect firms to take immediate steps where necessary to address the issues identified through our diagnostic work and reported here.
- We will conduct a Market Study to identify issues at the level of the market as a whole and set out solutions.
- Alongside the Market Study, we will initiate a public debate on the broader issue of fair pricing and the related possible harms within financial services markets.

1.18 Our Market Study will allow us to understand across the sector the scale of any harm and who it affects. Understanding this is crucial for identifying whether remedies are required and what form they may take. Our goal is to ensure that general insurance markets deliver competitive and fair pricing outcomes for consumers. We will act as required to ensure this happens, including where appropriate, taking steps that may fundamentally change pricing practices.

2 Background to our diagnostic work and theory of harm

2.1 As set out above, we committed to undertake diagnostic work on pricing practices for the GI sector in our 2017/18 Business Plan. This followed three 2016 FCA publications that raised concerns around GI firms' pricing practices. We noted that in certain circumstances, they may lead to poor outcomes for consumers. These papers were:

- A Policy Statement (PS16/21 – August 2016) on 'Increasing transparency and engagement at renewal in GI markets' which introduced new rules requiring firms to show the prior year's price on renewal notices.
- A Feedback Statement (FS16/5 – September 2016) following a 'Call for inputs on Big Data'.
- An Occasional Paper (OP22 – September 2016) on 'Price discrimination and cross subsidy in financial services'.

2.2 In FS 16/5, we stated that pricing practices resulting from the increased level of data available to firms may present consumer protection and competition concerns if:

- Firms charge different prices to different consumers for reasons other than risk or cost (with some being better off and others worse off) and those consumers who are worse off by paying higher prices, tend to be vulnerable or older consumers.
- Pricing for reasons other than cost or risk limits effective competition, for example by increasing barriers to entry.

These concerns were the starting point for developing the theory of harm we considered in our diagnostic work.

2.3 Our broad theory of harm is that some individual consumers (including vulnerable consumers) may pay significantly more than the efficient costs of supplying them with insurance over time. In some instances, this could result in harm or be an indicator of potential harm to these consumers.

3 Focus, scope and methodology

3.1 Given the range and complexity of GI pricing models and practices we decided to focus our diagnostic work on a single product. We selected home insurance as we believed it would provide the best illustration of potential consumer harm arising from current pricing practices, for example through less active renewal customers being charged significantly higher prices than new business customers with similar risk characteristics and costs to serve.

3.2 In the light of our concerns and theory of harm, our work focused on:

- Pricing governance, control and monitoring to consider whether firms had appropriate systems and controls in place around their pricing activities.
- Firms' pricing strategies to understand the objectives underpinning their pricing practices. This included considering whether these strategies took into consideration the impact of pricing practices and decisions on consumers and whether these were embedded within firms.
- Firms' pricing systems and operations to better understand how the pricing strategy was being delivered in practice and how home insurance policies were being priced. This included scenario testing and analysis to understand:
  - The extent to which the prices particular cohorts of consumers pay are above or below the risk premium and cost to serve.
  - The impact on price due to tenure and distribution method at a market level and for different consumer groups.
  - Variations in the above by firm.

3.3 The work performed consisted of:

- The development of a decision framework to diagnose potential harms arising from GI pricing practices.
- The selection of firms to include within the review.
- An initial information request to firms.
- Meetings and interviews with key firm personnel involved in pricing.
- A second information request consisting of pricing scenarios detailing the breakdown between technical price, expenses and margin.
- Supplemental information requests including due diligence and oversight of 3rd party data, complaints and renewal documents.

Firm selection and methodology

3.4 In total, 18 individual firms plus an appointed representative were included in the review. This allowed us to consider a representative sample of underwriters and intermediaries (both manufacturers and distributors) with different business models, to understand the different approaches and practices across the sector. Collectively, these firms distributed products through all major distribution channels (including direct, PCWs, broker, affinity partners[5] and networks[6]). The insurers within the sample accounted for over 40% of the home insurance policies written in 2016.

3.5 An initial information request was made, including information on firms':

- pricing strategy
- pricing governance, control and monitoring
- pricing model, including data and systems used for pricing
- pricing approach

3.6 Following our review of the initial information received, we visited all 18 firms and carried out over 100 meetings and interviews with key personnel at these firms involved in the pricing of home insurance. These meetings and interviews included individuals in roles like Director/Head of Pricing, Pricing Manager, Pricing Analyst, Pricing Implementation Manager and Data Scientist. This enabled us to develop a rounded understanding of each firm's approach to pricing from the senior leadership's pricing strategy through to the day-to-day pricing activity of analysts.

3.7 A second more detailed information request was then made seeking numerical information for the year ended 2016. This included the breakdown of the premium (excluding insurance premium tax) between the technical price/risk premium, expenses related to the cost to serve and the margin for a range of different consumer cohorts ('pricing scenarios'). This information was requested to enable us to better understand the range of pricing outcomes for household insurance consumers across a range of products, sales channels, rating factors and tenure. We also sought to identify any systematic pricing trends across the industry or by type of provider.

3.8 To help us with this diagnostic work, we appointed a team of actuaries from Deloitte (following a tender process) to provide support, insight, technical expertise and challenge.

3.9 We have engaged more broadly with the retail insurance sector (including via relevant trade bodies) during this work to better understand their thoughts and views on the pricing issues manifesting in the market.

5 Notable affinity partners included banks and retail brands.
6 Sup 12.2.6G A firm is referred to as a 'network' if it appoints five or more appointed representatives...

4 Our findings

Pricing strategy, governance and control

4.1 There is a significant risk of harm to consumers if firms fail to have appropriate and effective strategies, governance and controls in place to determine and monitor their pricing activities. These governance and controls mechanisms need to be underpinned by clear lines of accountability and responsibility so that firms appropriately consider and evaluate how pricing decisions impact consumer outcomes. This includes considering whether the pricing structure and approach meets our requirements on firms to have due regard to the interests of its customers and to treat them fairly.

4.2 To gain an understanding of firms' governance of their pricing activities we looked at:

- Firms' pricing strategies to understand the objectives underpinning their pricing practices. This included considering whether these strategies took into consideration the impact of pricing practices and decisions on consumers and were embedded within the firms.
- Firms' pricing governance, control and monitoring including accountability and responsibility to understand whether they had appropriate systems and controls in place for pricing.

4.3 As set out above, our work was Stage 1 diagnostic work to identify harm, potential harm or markets not working as well as they could, rather than Stage 2 diagnostic work to assess the extent and causes of any harm identified. Our findings should be considered in this context.

4.4 Our review of pricing strategies and philosophies suggested that some firms may not have consistently and appropriately considered the impact of their pricing decisions on consumers. For example, 3 of the firms in the review did not have any documented pricing strategy or philosophy and used their business plans as the sole driver of their pricing activities. This meant there was limited evidence that these firms and relevant senior management were appropriately considering the impact of their pricing strategy on their customers.

4.5 Where firms had a pricing strategy in place, this was usually appropriately communicated to those involved in pricing activities. However, while pricing staff understood what the firm was seeking to achieve through their pricing approach, this was not always fully reflected in practice. In many firms, pricing decisions appeared to be focused primarily on achieving business plan and financial objectives. There was little or no explicit consideration (including by relevant senior management) of the impact of the resultant pricing decisions on their customers. In some cases, though impact on the customer was a factor on the pricing decision document, the pricing staff involved in the operation of the pricing models and preparation of these pricing decision documents were not aware of this.

4.6 We also found that the governance and controls around pricing activities were of variable quality across the sample of firms included within our diagnostic work. In a number of cases it appeared from the information provided that firms' pricing governance and controls were not consistently effective or appropriately embedded. One key element of this was that in many cases we found that the Board and the Executive Committee were too distant from pricing decisions and/or were applying insufficient oversight for it to be apparent how they could be satisfied that all customers were consistently being treated fairly though their pricing activities.

4.7 Further, there was lack of clarity in some firms over who was ultimately responsible for a range of pricing related decisions. This is despite the introduction of the Prudential Regulation Authority's (PRA's) Senior Insurance Managers Regime (SIMR) and revised Approved Persons Regime[7]. In some firms, although the responsibility for pricing decisions was clearly allocated and delegated on paper, this was not always reflected in practice. When we asked questions in meetings with key personnel about who was ultimately responsible for issues or errors arising in pricing, in many cases more than one person was named. In one firm, the team responsible for technical pricing and propensity modelling reported to an individual who had no delegated authority for pricing. When asked about this, the firm said it was looking to review this position.

4.8 The firms in our review did generally have processes for escalating pricing decisions based on some impact measure of the decision eg economic gain, profit, or gross written premium (GWP). However, these were not normally considered or expressed in relation to their impact on their consumers, and in a couple of firms it was not clear what issues should be escalated. These escalation processes used generic terms such as 'major rate changes' or 'rate changes of particular interest' to identify decisions requiring escalation to the Pricing Committee. This effectively left these escalation decisions entirely at the discretion of the senior members of the Pricing Team.

4.9 Another issue was that many firms had legacy home insurance products on legacy systems. They found it challenging (or impossible) to interface these with newer systems, or to compare the pricing of these products to that of their newer products. This meant that in many cases consumers who were renewing older legacy products supported on old systems were not benefitting from the same level of pricing governance and scrutiny as consumers purchasing new products. The newer products almost always had more dynamic and competitive pricing models and were subject to a much greater level of management oversight and review.

4.10 A further area of concern regarding the governance and control of pricing is relevant to all the firms in our review and relates to the production and use of management information (MI). It was not clear to us that:

- Firms had developed an appropriate suite of MI to consider the impact of pricing decision on their customers.
- The analysis of any available MI was performed consistently and was appropriately considered by senior management, including by Executive Management or the Board.

7 Provides a regulatory framework for standards of fitness and propriety, conduct and accountability to be applied to individuals in positions of responsibility at insurers.

- Issues relating to price and consumer outcomes were identified and addressed through MI and other monitoring activities.

4.11 For example, many firms did not have appropriate MI to identify and analyse outliers (either books of business, cohorts of consumers or individuals) in terms of margin or profitability. Some firms had implemented, or were in the process of implementing, strategies to reduce prices over time for those consumers who were paying higher than average margins. However, they could not always tell us how many consumers were impacted, the size of the margin, the size and effect of the reduction or the timescales over which such reductions were to be applied before they would be normalised.

4.12 Firms' MI packs on pricing frequently included graphs or tables with limited or zero commentary. In many firms, we found no evidence of further analysis or discussion of the information. Consequently, these packs gave no real assurance that there was consistent scrutiny and interpretation of MI, particularly by senior management personnel with less detailed understanding of pricing, or that issues were identified and actions taken based on this MI.

4.13 Our final concern is about customer vulnerability and firms' pricing activities. All the firms included in our work had a vulnerable consumer strategy and used the ABI/ The British Insurance Brokers' Association (BIBA) guidance to recognise vulnerable consumers. However, we identified that this was mainly used in the contact centre when interacting with customers on a personal basis and not for pricing decisions. Many firms told us that a vulnerable consumer strategy was difficult to implement in practice for pricing, as it was not always easy to identify vulnerable consumers other than by their age[8]. This means that it is likely that many firms are not able to consistently and reliably take into consideration all their vulnerability factors in their pricing activities. This potentially places these consumers at greater risk of suffering harm because of firms' inappropriate pricing practices.

Differential pricing

4.14 The data obtained from firms about the prices and margins paid by different cohorts of customers in different scenarios provided widespread evidence of differential pricing occurring within home insurance pricing. This differential pricing appears to support extensive cross-subsidisation between different cohorts of consumers. In particular, in many firms there appears to be significant cross-subsidisation of new business consumers through higher margins from renewal consumers. In addition to established firms cross-subsidising the acquisition of new business from renewal consumers, newer market entrants appear to be cross-subsidising new business in other ways through, for example, margins on premium finance and add-ons, and by levying fees and charges. The newer entrants predominantly acquired consumers through PCWs

8 Some of the metrics firms used for recognizing vulnerability in terms of pricing included:
- Age, for example consumers aged over 70
- Consumers who have not shopped around for a few years.
- Consumers who have limited access to market. For example, consumers who live in areas where there is a history of subsidence or flooding. The price would be based on the risk only and consumers would not be charged a higher premium because there was less competition for these types of consumers,
- Disabled consumers, for example, by not increasing the premium mid-term if a property was modified for disabled access.
- Vulnerable consumers who had live in carers by, for example, not treating carers as lodgers which would usually result in a lower premium.

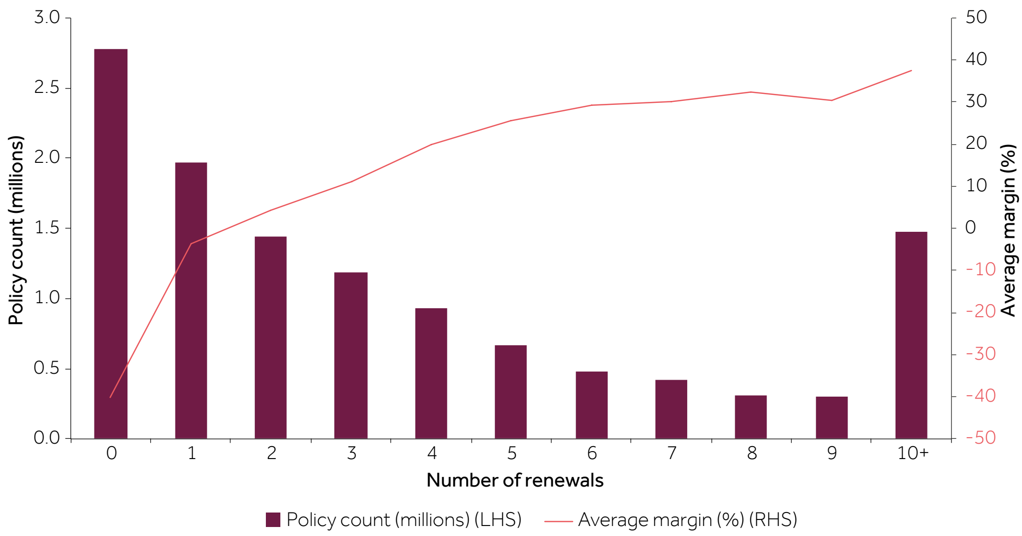
and had far fewer long term renewal consumers. For many new business consumers, the price of the insurance product itself was significantly below the cost of provision so newer entrants have used these other ways to generate an acceptable margin on the supply of insurance.

4.15 The greatest potential for harm we identified arose from the price differentiation relating to long term renewal consumers. This is particularly in those firms with larger books of older renewal business (including back book and legacy products). Our work showed that cohorts of consumers who have renewed their home insurance with their insurer for many years are on average paying prices significantly above the cost of provision.

4.16 There was evidence of significant price competition for new customers with new policies often priced as much as 30% below the cost of provision. The firms included in our review generally aimed to break even on new business (on a forward-looking basis) after 2 to 3 years, via sharp premium increases in years 2 and 3. The variation in premium increases between distribution channels was pronounced.

4.17 The insurers included in the review account for around 40% of the UK home insurance market. Figure 1 below illustrates the findings based on year end 2016 information provided through the pricing scenarios. The average margin for cohorts of consumers has been calculated using a number of assumptions to allocate costs. So, it may not accurately reflect the costs experienced in servicing that particular cohort of customers. Additionally, there is likely to be significant variance in the margins for individual consumers within each of these cohorts. Finally, this only reflects the margin on sale of the core home insurance product, and does not take into account any margins arising from related sales (such as premium finance and add-on insurances) or from subsequent fees and charges.

Figure 1: Policy count and average margins by number of renewals



4.18 Noting the limitations to this information and analysis (as detailed above), Figure 1 appears to show that there is some cross-subsidisation occurring in this market. This produces both 'winners' and 'losers'. The evidence obtained through our diagnostic work suggests the following categories of consumers may be more likely to be potential winners and losers from current pricing practices in home insurance[9]:

- Potential winners: a higher proportion of these may be found in the front book/newer cohorts of business. Examples of consumer groups who are potential winners from the scenario analysis with lower average margins and policy tenures include private renters with children, those with low credit scores, unemployed renters and those with contents only insurance. There is a direct correlation between those groups of consumers who have lower tenure (have been with the insurer for fewer years) and those who generate a lower margin. This is because these groups of consumers are most likely to shop around.

- Potential losers: a higher proportion of these may be found in the renewal book. Examples of consumers groups who are potential losers from the scenario analysis with higher average margins and policy tenures include those who are over 65 years old, those who pay monthly, those who auto-renew, those who have made previous claims[10] and those who have buildings only insurance. There is a direct correlation between those groups of consumers who have higher tenure and those who generate a higher margin.

The above categorisation of consumers into potential winners and losers relates solely to the average margin on the core home insurance purchase. This margin has been calculated using a number of assumptions. As noted, this categorisation does not reflect the complete picture. There will be significant differences between individual consumer margins within each cohort, the allocation methodology used may not accurately reflect the true costs to serve these cohorts of customers and the categorisation could be affected if margins on the sale of related products or on additional charges levied to consumers were considered.

4.19 Many of the firms included in our diagnostic work had, or were in the process of introducing, a dedicated strategy for reducing the price differential between new and renewal consumers. Where firms had already performed some analysis of the price differential, they had often identified that it was particularly large for those consumers with longer tenure. However, the degree of development, aims, pace and likely effectiveness of these strategies to reduce price differentials varied significantly.

Potential for discrimination through pricing based on protected characteristics

4.20 We found no evidence of direct discrimination based on protected characteristics. Even so, we are concerned about the potential harm to consumers which could arise if firms act contrary to law with regards to the Equality Act 2010 and the Rehabilitation of Offenders Act 1974. These concerns are about issues such as potential discrimination

9 Firms did not complete all scenarios as some were not applicable/or information could not be provided, so the results of some individual scenarios are representative of less than 40% of the market eg the firms that provided data on low credit score scenarios account for around 12% of the market. Where a firm did not provide data for a particular scenario, it did not mean that it was not a pricing factor used by that firm.

10 After taking into account the risk premium impact of the claim.

by using data in pricing which are implicitly based on race and firms not communicating clearly to customers about disclosure of spent convictions.

4.21 Our main concern in this area is the potential use of data based on race/ethnicity within firms' pricing models to produce different offered prices. We found no evidence to date of this type of direct discrimination. However, we did find that firms were using datasets (including datasets purchased from third parties) within their pricing models which may contain factors that could implicitly or potentially explicitly relate to race or ethnicity. Some firms have determined that the use of certain data is not appropriate and do not incorporate this type of data in their pricing models. Other firms informed us that they believe that such datasets can be used for pricing purposes as the mining of the data represents a proportionate means of achieving a legitimate aim, which would be permitted under the Equality Act 2010.

4.22 Firms were asked how they gained assurance that the third-party data they used in pricing did not discriminate against certain customers based on any of the protected characteristics under the Equality Act 2010. Many firms could not provide this assurance without first contacting the third-party provider. Further, some firms responded that they relied on the third-party provider to comply with the law and undertook no specific due diligence of their own to ensure that the data were appropriate to use.

4.23 Overall, we found that where firms used external data within their pricing models, appropriate due diligence was not always undertaken to ensure that the data did not include factors that might have the potential to discriminate based on protected characteristics. This meant that in a number of cases firms had to undertake further work to answer our questions about this. We had anticipated that those questions would have been explicitly addressed in the firm's due diligence before using the dataset in their pricing model.

4.24 We expect firms to comply with their legal obligations and ensure that they have appropriate controls in place for doing so. Firms should ensure, that the way in which they use data (including consumers' personal data) or ask questions of consumers when providing insurance, is in line with all relevant laws and regulations and supports the fair treatment of their consumers.

5 Our expectations of firms

5.1 We consider pricing to be one of the most significant business activities for general insurers and those intermediaries undertaking this activity, with the potential to cause significant harm to consumers. Based on our findings, we have significant concerns about the potential for harm and poor consumer outcomes arising from firms' pricing activities, including for vulnerable consumer groups. So, we are reiterating to firms how our existing rules and guidance are relevant to pricing activities and thus our expectations of firms in this area.

5.2 There are no set numerical parameters regarding what constitutes a fair price for general insurance products. However, we expect firms to consider whether their pricing activities and the resulting outcomes could harm their customers. We also expect firms to have appropriate systems and controls which support the fair treatment of customers when determining prices and selling products. This reduces key risks such as exploiting vulnerable and less active consumers or providing misleading information to consumers.

5.3 In line with the Principles for Businesses (PRIN), COCON, APER, ICOBS, PROD and SYSC in our Handbook[11], we expect all firms to comply with FCA rules in overseeing and carrying out pricing activities. In particular, this includes paying due regard to the interest of customers and ensuring they are treated fairly when they purchase or renew their general insurance products. These are fundamental obligations which authorised firms must comply with.

5.4 We expect firms to take reasonable care to establish and maintain such systems and controls as are appropriate to their business. We expect this to include consideration of a firm's pricing activities and whether its governance and control over these activities are appropriate.

5.5 We expect management information (MI) on firms' pricing activities to enable senior management at all levels to understand the impact of pricing decisions not only on business performance but also on the firm's customers. This should include MI that identifies, measures, manages and controls risks of regulatory concern. Risks of regulatory concern relate to the fair treatment of the firm's customers and thus the protection of consumers, effective competition and the integrity of the UK financial system. The detail and extent of information required will depend on the nature, scale and complexity of the business.

5.6 We would expect firms to clearly identify who is responsible for pricing decisions, as is required by the PRA's SIMR and our revised Approved Persons Regime. These regimes provide a regulatory framework for standards of fitness and propriety, conduct and accountability to be applied to individuals in positions of responsibility at insurers. The essential principles of these regimes include:

- Senior managers are clearly accountable for decisions and conduct that fall within their areas of responsibility.

11 In particular, Principles for Businesses 1, 2, 3, 6, 7, and 8; COCON, APER, ICOBS, PROD 4; SYSC 2; SYSC 3; SYSC 4; SYSC 14.

- Senior managers are clearly accountable for ensuring that they have taken reasonable steps to ensure that the decisions made by individuals in their areas are appropriate (eg through governance and control frameworks).

It was not clear that this framework had been consistently implemented and embedded for pricing activities in GI firms.

5.7 We further expect the right culture to be promoted throughout firms by ensuring that individuals working at all levels can be held to appropriate standards of conduct. Under the impending Senior Managers' and Certification Regime (SM&CR), senior managers, both at insurers and in intermediary firms, will be held accountable for conduct that falls within their area of responsibility. The onus is put on firms to assess the fitness and propriety of certified employees who could cause significant harm to a firm or its customers.

5.8 Further, firms are expected to consider the impact of new rules which came into force on 1 October 2018 which implement the EU Insurance Distribution Directive (IDD). These rules include PROD 4.2.25R which says that insurance product manufacturers must consider the charging structure proposed for each product and ICOBS 2.5-1R which requires that a firm must act honestly, fairly and professionally in accordance with the best interests of its customer. We expect firms to be ready for these rules by having a clear pricing strategy that considers the impact of pricing decisions on their customers and which recognises the obligation to act in accordance with the best interests of its customers.

5.9 Firms should comply with their legal obligations and ensure that they have appropriate controls in place for doing so. Firms' senior management must also act with integrity (COCON 2.1.1R). Firms should also consider whether the way in which they use consumers' personal data, external data or ask certain questions represents fair treatment of their customers. Senior management should keep these responsibilities in mind when mapping the accountability and responsibility for the impending SM&CR.

5.10 We expect firms to undertake appropriate due diligence where they use data from third parties in the pricing of GI products and to ensure that the use of data is appropriate and complies with law. A firm must take reasonable steps to establish and maintain adequate internal controls. This includes ensuring compliance with its internal policies and procedures as well as all applicable laws and regulations (SYSC 14.1.27R,14.1.28G and 14.1.29AG; ICOBS 2.5.3G).

5.11 Firms are required to comply with their legal obligations including under the Rehabilitation of Offenders Act 1974 and the Equality Act 2010.

5.12 In Annex 1, we set out the key provisions of the Handbook rules and guidance we have considered and relied upon in this review. The rules and guidance referred to in this report and the annex are not intended to be an exhaustive list of regulatory obligations and other regulatory and legal provisions may also be relevant depending on the circumstances.

6 Our actions and next steps

6.1 We are concerned that general insurance pricing practices have the potential to cause harm to consumers, particularly those who are vulnerable. We will address this by:

- Using our supervisory powers to require firms to tackle evidence of harm and we expect firms to take immediate steps where necessary to address the issues identified through our diagnostic work and included in this report.
- Conducting a Market Study to identify issues at the level of the market as a whole, consider whether competition is working effectively and set out solutions.
- Facilitating a public debate on the broader issue of fair pricing and the related possible harms within financial services markets. This will be initiated by publishing a discussion paper in October 2018. This process will run in parallel to the Market Study. The discussion paper will explore findings from prior FCA work including the FCA's recent Call for Input on Access to Insurance. It will look beyond general insurance and draw on existing evidence of price differentiation in other markets eg cash savings, mortgages. This work would build on the FCA's Approach to Consumers, which tackles a number of relevant areas such as consumer and firm responsibility, consumer protection, access and vulnerability.
- Proactively communicating these findings to industry and other stakeholders.
- Continuing to engage with relevant trade bodies to discuss pricing practices and related issues as we perform the Market Study. We acknowledge the work that the ABI and BIBA have already done to introduce pricing practices guidelines for their members. However, we note the need to perform the Market Study to determine whether broader regulatory intervention is required to ensure that these markets work well for all consumers.
- Writing to the CEOs of all general insurers and a targeted group of GI intermediaries who undertake pricing activities. This is to ensure that firms address the specific issues we identified through the first phase diagnostic work, alongside the performance of the Market Study.
- Engaging consumer groups in the discussion on fair pricing across financial services markets and seeking to understand any other concerns they may have in relation to general insurance pricing practices.
- In addition, we continue to discuss with firms and relevant stakeholders the issues of concern (potential harm and possible non-compliant behaviour) we have found in individual cases.

6.2 In addition, we are undertaking a post-implementation review to evaluate the effectiveness of PS16/21 – 'Increasing transparency and engagement at renewal in GI markets'.

Annex 1
Existing and impending FCA Handbook rules and guidance and other legal obligations

1. FSMA, other applicable legislation and our Handbook supplemented by relevant guidance, set out a number of obligations to which authorised firms are subject in relation to pricing. Firms must comply with all applicable legal requirements.

1. **The relevant existing sections of the Handbook include:**

- The Principles for Businesses (PRIN)
- Senior Management Arrangements, Systems and Controls (SYSC) 2,3, 4 & 14
- Code of Conduct (COCON)
- FCA Approved Persons (SUP 10A)
- Statements of Principle and Code of Practice for Approved Persons (APER)
- Insurance Conduct of Business Sourcebook (ICOBS)
- Product Intervention and Product Governance Sourcebook (PROD)

2. **Impending changes to the Handbook include:**

- The implementation of Senior Managers and Certification Regime (SM&CR)

3. **And applicable legislation includes:**

- The Financial Services and Markets Act 2000 (FSMA)(The Act)
- The Data Protection Act 2018 including the General Data Protection Regulation (GDPR)
- The Equality Act 2010
- The Rehabilitation of Offenders Act 1974

The relevant existing sections of the Handbook

2. Below, we have set out the key provisions of the FCA Handbook rules and guidance that we have considered and relied upon when undertaking this review. The rules and guidance referred to in this annex are not an exhaustive list of regulatory obligations and other regulatory and legal provisions may also be relevant depending on the circumstances.

3. We also include brief information on impending rules and guidance that firms should also consider with regards to their pricing activities.

Principles for Businesses (PRIN)

4. The Principles for Businesses are obligations that all authorised firms must comply with. While all the Principles are relevant, the following are the Principles (PRIN 2.1.1 R) we relied upon in undertaking this review on firms' pricing practices.

- Principle 1 – 'A firm must conduct its business with integrity'.
- Principle 2 - 'A firm must conduct its business with due skill, care and diligence'.
- Principle 3 - 'A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems'.
- Principle 6 - 'A firm must pay due regard to the interests of its customers and treat them fairly'.
- Principle 7 – 'A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading'.
- Principle 8 - 'A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client'.

Senior Management Arrangements, Systems and Controls (SYSC)

5. The purposes of SYSC (SYSC 1.2.1G) are:

1. to encourage firms' directors and senior managers to take appropriate practical responsibility for their firms' arrangements on matters likely to be of interest to the FCA because they impinge on the FCA's functions under the Act
2. to increase certainty by amplifying Principle 3, under which a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems
3. to encourage firms to vest responsibility for effective and responsible organisation in specific directors and senior managers
4. to create a common platform of organisational and systems and controls requirements for all firms

Insurers[12]

6. SYSC requires that a firm must take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers in such a way that it is clear who has which of those responsibilities and the business and affairs of the firm can be adequately monitored and controlled by the directors, relevant senior managers and governing body of the firm (SYSC 2.1.1 R).

7. SYSC also requires that a firm must take reasonable care to establish and maintain such systems and controls that are appropriate to its business (SYSC 3.1.1 R).

12 Including incoming EEA firms in respect of (in general) business carried on from a UK establishment, save to the extent that the matter is reserved under EU law to the home state regulator.

Guidance set out in SYSC indicates that the complexity and diversity of its business should be relevant factors to be considered by a firm, and that firms should carry out regular reviews to ensure ongoing appropriateness (SYSC 3.1.2 G). In addition, a firm must take reasonable steps to establish and maintain adequate internal controls (SYSC 14.1.27 R).

8. SYSC also applies to incoming EEA firms for activities carried on from an establishment in the UK.

Intermediaries

9. An intermediary must have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility. Further it must have effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems (SYSC 4.1.1 R). These arrangements, processes and mechanisms should be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the business model and of the firm's activities (SYSC 4.1.2 R and SYSC 4.1.2A G).

The Prudential Regulation Authority's (PRA's) Senior Insurance Managers Regime (SIMR) and revised Approved Persons Regime

10. The PRA's SIMR and our revised Approved Persons Regime provides a regulatory framework for standards of fitness and propriety, conduct and accountability to be applied to individuals in positions of responsibility at insurers.

11. One of the intentions of the SIMR and revised Approved Persons Regime is to ensure a clearer allocation of responsibilities to the most senior individuals within a firm to minimise the potential for gaps and overlaps in accountability. Jonathan Davidson, Director of Supervision for Retail and Authorisations, gave a speech on 12 July 2016 in which he set out the essential principles of the SIMR / revised Approved Persons Regime. These included:

- Senior Managers are clearly accountable for decisions and conduct that fall within their areas of responsibility.
- Responsibility for conduct should not fall through the cracks within an organisation or be shared so widely that no one feels accountable for it.
- Senior managers are clearly accountable for ensuring that they have taken reasonable steps to ensure that the decisions made by individuals in their areas are appropriate (eg through governance and control frameworks).
- Senior managers are clearly accountable for ensuring individuals working at all levels meet appropriate standards of conduct and competence.

Statements of Principle and Code of Practice for Approved Persons (APER)

12. This is the section of the Handbook that sets out the High-Level Standards for Approved Persons and which has the title Statements of Principle and Code of Practice for Approved Persons. The purpose of the Code of Practice for Approved Persons is to help an approved person to determine whether or not that person's conduct complies with a Statement of Principle (APER 3.1.1A G).

The Code of Conduct (COCON)

13. COCON sets out the rules and guidance to firms whose staff are subject to them and COCON 1.1.2R sets out the list of persons to whom COCON applies.

14. COCON 2.1 sets out the individual conduct rules as follows which apply to all conduct rules (CR) staff13

1. CR 1: You must act with integrity (COCON 2.1.1R)
2. CR 2: You must act with due skill, care and diligence (COCON 2.1.2R)
3. CR 3: You must be open and cooperative with the FCA, PRA and other regulators (COCON 2.1.3R)
4. CR 4: You must pay due regard to the interest of customers and treat them fairly (COCON 2.1.4R)
5. CR 5: You must observe proper standards of market conduct (COCON 2.1.5R)

15. COCON 2.21415 sets out the rules that apply to senior conduct rules staff members as follows:

1. SC 1: You must take reasonable steps to ensure that the business of the firms for which you are responsible is controlled effectively (COCON 2.2.1R)
2. SC 2: You must take reasonable to steps to ensure that the business of the firms for which you are responsible complies with the relevant requirement and standards of the regulatory system (COCON 2.2.2R)
3. SC 3: You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively (COCON 2.2.3R)
4. SC 4: You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice (COCON 2.2.4R)

FCA Approved Persons (SUP 10A)

16. This section of the Handbook specify descriptions of FCA controlled functions under section 59 of the Financial Services and Markets Act 2000 (Approval for particular arrangements)(SUP 10A.1.3 G).

Insurance Conduct of Business Sourcebook (ICOBS)

17. ICOBS sets out the standards that apply to all non-investment insurance product sales (general insurance and protection policies). ICOBS was amended due to Implementation of the Insurance Distribution Directive (IDD). These changes took effect from 1 October 2018 and 1 of the changes included the amendment of ICOBS 2.5 to include the customer's best interest rule. The new ICOBS 2.5.-1 R states 'A firm must act honestly, fairly and professionally in accordance with the best interests of its customer'.

13 COCON 1.1.3R - Rules 1 to 5 in COCON 2.1 apply to all conduct rules staff.
14 COCON 1.1.4R (1) Rules SC1 to SC4 in COCON 2.2 apply to all senior conduct rules staff members (subject to (2)).
15 COCON 1.1.4R (2) SC1 to SC3 in COCON 2.2 do not apply to a standard non-executive director unless, as well as being a standard non-executive director, they also fall into one of the other categories of senior conduct rules staff member.

Product Intervention and Product Governance Sourcebook (PROD)

18. The Handbook was also amended to include the IDD's Product Oversight and Governance (POG) Regulation which states under PROD 4.2.25 R 'that Manufacturers must consider the charging structure proposed for each insurance product, including examination of the following:

1. whether the costs and charges of the insurance product are compatible with the needs, objectives and characteristics of the target market
2. where relevant, whether the charging structure of the insurance product is appropriately transparent for the target market, such as that it does not disguise charges or is too complex to understand
3. where relevant, whether the charges undermine the return expectations of the insurance product, such as where the costs or charges equal, exceed or remove almost all the expected tax advantages linked to a life policy'

19. PROD 4.2.25R is supported by guidance under PROD 4.2.26 G which states:

1. 'PROD 4.2.25R does not affect the manufacturer's freedom to set premiums.
2. In relation to a non-investment insurance contract a firm should consider whether, as a result of the charging structure it has put in place, the overall cost for the customer is consistent with its obligations under the Principles and ICOBS'.

Impending rules and guidance

Senior Managers and Certification Regime (SM&CR)

20. The SM&CR will come into effect on 10 December 2018 for Insurers and for all other FSMA authorised firms that are regulated solely by the FCA (including Intermediaries) on 9 December 2019. The PRA's SIMR and the revised Approved Persons Regime for insurance firms will be replaced by the new SM&CR regime.

21. The aim of the SM&CR is to reduce harm to consumers and strengthen market integrity by creating a system that enables firms and regulators to hold people to account. As part of this, the SM&CR aims to ensure that:

- Senior managers can be held accountable for conduct that falls within their area of responsibility.
- The onus is put on firms to assess the fitness and propriety of certified employees who pose significant harm to a firm or its customers.
- The right culture is promoted throughout firms by ensuring that individuals working at all levels can be held to appropriate standards of conduct and take personal responsibility for their actions.
- Firms and staff clearly understand and can demonstrate where responsibility lies.

22. Additional information on the SM&CR can be found at:

1. Extending the Senior Managers & Certification Regime to insurers – Feedback to CP17/26 and CP17/41 and near-final rules:
https://www.fca.org.uk/publication/policy/ps18-15.pdf

2. Extending the Senior Managers & Certification Regime to FCA firms – Feedback to CP17/25 and CP17/40, and near-final rules:
https://www.fca.org.uk/publication/policy/ps18-14.pdf

3. Final Guidance: The Duty of Responsibility for insurers and FCA solo-regulated firms:
https://www.fca.org.uk/publication/policy/ps18-16.pdf

4. The Senior Managers and Certification Regime: Guide for insurers:
https://www.fca.org.uk/publication/policy/guide-for-insurers.pdf
The Senior Managers and Certification Regime: Guide for solo-regulated firms:
https://www.fca.org.uk/publication/policy/guide-for-fca-solo-regulated-firms.pdf

5. Relevant sections of the Handbook.

Annex 2
Glossary of terms

Back book	The book of business consisting of existing customers who have held their current insurance product for more than a year. This would include customers renewing legacy products and long-standing customers (see also front book and legacy product below).
Burning cost	The estimated cost of claims in the approaching period of insurance generally calculated based on previous years' experience adjusted for changes in exposure (eg total sum insured) inflationary factors and the nature of cover (see also risk premium below).
Cost of provision	The sum of the risk premium and the cost to serve.
Cost to serve	The actual business activities and overhead costs incurred to service a particular consumer. This includes among other things, acquisition and claims handling costs.
Front book	The book of business consisting of new customers and include policyholders who have held their current insurance product for less than a year (see also back book above).
Insurers (or 'underwriters')	Regulated general insurance firms who take on insurance risk. In some cases, insurers will also manufacture and distribute their insurance products.
Intermediaries	Regulated general insurance intermediaries including both distributors and manufacturers. Intermediaries do not take on insurance risk.
Margin	The amount of the price charged which is in excess of or below the cost of the provision of cover. For the purposes of this report, margin is the amount of premium (excluding insurance premium tax) left over after the deduction of the cost of claims and expenses.
Legacy products	Products that are no longer sold as a new business product and can only be renewed.
Personal Lines	Insurance cover that protects families or individuals against financial losses and for general insurance includes products such as home, motor, travel and pet insurance.
Pricing strategy	Long term strategic pricing approach and goal.
Propensity model	A model used to optimise the prediction or likelihood of a specific event occurring, for example, customer behaviour and their likelihood to buy or switch.

Protected characteristics	There are nine protected characteristics under the Equality Act 2010. They are age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation. There are certain circumstances that allow the use of protected characteristics in GI pricing when it is a proportionate means of achieving a legitimate aim.
Rating Factor	A characteristic about the individual buying the insurance, their behaviours or a detail about the property/item being insured and is used for example, to rate the likelihood of the individual making a claim, the cost of a claim should it occur, the consumer's propensity to buy / price elasticity for the insurance cover.
Risk premium (or technical premium/price)	The forward-looking estimate of the burning cost for a given consumer (see also burning cost above).
Tenure	The length of time a consumer has been with the same insurer.

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