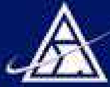
17th General Insurance Seminar
Risk and Reward



Institute of Actuaries of Australia

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An Overview of Consumer Credit Insurance

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4. Loss Ratio Analysis
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Introduction
Rationale for Paper on CCI

- Recent regulatory focus in Australia and overseas has potential to change way product is sold
- Relatively small segment of market – but historically well performed
- Underwriting performance strongly linked to economic indicators – how has the industry performed through the GFC?
- Given APRA's current review of capital standards – what can historical loss experience tell us about the appropriate level of capital for CCI business?

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What is Consumer Credit Insurance (CCI)?

- Insurance offered with most credit instruments, though predominantly offered against Mortgages, Personal Loan and Credit Card contracts
- Distinction also exists between Consumer and Business related Credit Insurance.
- Benefits:
  - *Lump sum* benefit payable on the event of death, terminal illness, TPD or trauma; as a fixed amount, the original loan amount or current balance → ***typically written by life insurers***
  - *Income replacement* benefit may include the events of sickness, accident or involuntary unemployment; paid as % of the original or current loan repayment or % of current credit card balance → ***typically (but not always) written by general insurers***

Our presentation will focus on CCI from a general insurer's perspective

Market Size and Participants

Market size: GI $313m[1] (≈$550m-$600m incl. life)

Bank Competitors

MLC

Metlife

Hallmark, Allianz

Other Competitors

Swann, AXA, CrediCorp

Hallmark

Cuna

Swann, AXA

ACE, Metlife

Other Credit Unions

Motor dealer networks

IMB, Once Credit (St.Andrews)

- Market dominated by banks, where product sold linked with credit
- Low product development as focus on x-sell and securing distribution
- Higher barriers to entry with mono-line distributors

Distribution:

- Call centre – inbound and outbound
- Branches – bank and Credit unions
- Mortgage brokers
- Direct mail
- Dealer groups

1. APRA General Insurance statistics Dec. 2009: Gross Premium Revenue

Underwriting and Design

- Limited at time of application, in-line with
  - distribution through call centre, direct mail, telemarketing, internet or OTC
  - simple the sales process and optimize time spent with the customer.

  Practice varies from no underwriting to short-form questionnaire.
- “Claim” underwriting through PEC exclusion. PEC definition may vary between product types, with more restrictive conditions often imposed for larger sums insured
- Additional exclusions generally included (eg. suicide, war, self-inflicted injury, alcohol)
- Specific high risk activities often excluded, taking the place of underwriting loadings or exclusions.
- Eligibility criteria quite wide, usually ages of 18 and 60+. Additional employment criteria may apply
- Lump sum benefits from a few thousand for Loan, up to $1m+ on MPI. CC benefits vary from zero $100k.
- Disability maximum monthly benefit specified up-front. Absolute total benefit often equaling the lump sum benefit. Unemployment benefits often lower than Disability, with shorter benefit periods.

Pricing Methods

Loan and Mortgage Insurance

- Relatively simple given distribution channels, with the majority using loan amount, age, and loan term as rating factors. Several more advanced pricing structures also adopt gender and smoking status.
- Pricing may be single premium (up-front) or regular premium (stepped or level).
- May offset cost of primary purchase, e.g. discounted loan interest rate.
- Developing more detailed pricing has been limited by the need for an efficient sales process and often separate distribution network outside the insurer domain.

Credit card Insurance

- Rates usually expressed as a rate per month per $100 outstanding balance, independent of age, sex and smoking status. The premium is charged monthly to the credit card account.

CCI as Life or GI business?

- Within the industry CCI may be issued solely through a Life company, or with non-life benefits issued through a General Insurance company and the remainder through a Life company
- Considerations in deciding which entity to issue:
  - Capital requirements differ significantly between Life and General Insurance
  - GST treatment of cash flows differs
  - Guaranteed renewable business through Life, while able to cancel insurance in General insurance entity
  - Expense deferral over policy term, where policy term covers multiple periods for Life and only single renewal period for General Insurance
  - Possible stamp duty differences – though tends to look through entity structure
  - Statutory reporting differences – prospective vs. accumulation, though both produce planned profits in proportion to exposure / profit carrier
  - GI risk margins in P&L, while Life P&L based on Best Estimate assumptions
  - Administration may be simpler within the same entity, not requiring notional premium splitting

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Current Regulatory Framework

- Insurance Contracts Act
- National Consumer Credit Protection Act 2009
- ASIC (taking over from the ACCC)
- APRA
- Industry Regulation (FSC, Insurance Council)
- Financial Services Reform Act (2001)
- Trade Practices Act
- Corporations Act

CCI Industry – history of recent regulatory change and review

1992	1994	1995	1996
- GWP report to implement CCI recommendations (1991)	- Insurance Contract Act changes - ISC more detailed and regular data - GWP report and recommendations	- Uniform Consumer Credit Code - Consumer Credit Act 1994	- ACCC CCI review commences

2000	2001	2002	2005
- GST introduced	- Financial Services Reform Legislation	- Training and compliance with PS146	- EU by GE Money to amend Hallmark selling practices - General Insurance Code of Practice

2007	2008	2009	2010
- UK CC - Provisional Findings report - Insurance Contracts Act - reform package	- Restrictions on GE Money AFSL	- Release of UK PPI Report - National Consumer Credit Protection A - ASIC review selling practices of Citigrou - Choice article- Credit Insurance sham	- ASIC Review of CCI Industry - Insurance Contracts Act Amendment Bi - FSC drafting industry self-reglatory indu - Insurance Conuncil CCI Working Group to draft CCI Code of Practice - revised GI Code of Practice

Source: 1992-1998 ACCC CCI Paper, updated to current date.

ACCC - CCI Review 1998

Problem	Comment	Since 1998
Price and cost of CCI	High commissions for access to distribution and training costs	UCCC capped commissions at 20%. Other management and administration fees paid.
Lack of competition at Point of Sale	• Secondary sale is typical basis, resulting in low competition and high profit margins • Agents sell mostly through one insurer. • Comparison difficult due to complexity of transaction, lack of product familiarity, infrequency of purchase	Distribution remains largely unchanged with insurers securing specific channels, e.g. Credit Unions, motor dealer groups
Training of advisers	Improved, though some groups remain inadequate, esp. those employed by licensed or trained person.	FSRA introduced licensing, training and advice regulations.
Provision of information to consumers	Improved, though remaining issues: • limitations on unemployment cover • restrictive clauses, esp. pre existing conditions (PEC) • lack of knowledge of having purchased insurance	Product design largely unchanged, with recent improvements. Main product design is PEC to suit direct distribution method.
Policy Content	Scope for more change. Little to date reflecting appropriate product or product with little competition on content or price.	Undynamic due to low competition. Conditions have changed in response to sales practices.
Complaints handling	Confusion as many avenues available. Frustration that single panel cannot deal with sales and marketing practices, along with claim dispute resolution.	FOS as an External Dispute Resolution (EDR) scheme approved by ASIC. Also includes FICS.
Inappropriate sales	• Policies sold to those ineligible to claim, possibly due to generic nature of product • Minor issue of sales being sold where major benefits are excluded, e.g. PEC	More unbundling of benefit options, though some remain bundled, e.g. Credit Card insurance. Broader unemployment coverage

Has enough changed?

- Have issues from 1998 been adequately addressed?
  - Is the consumer value proposition adequate?
  - Has the industry moved enough in terms of sales practice, product design and self-regulation?
  - Is profitability a concern, or have loss ratios enjoyed a sustained period of economic prosperity, that will jump as the cycle turns?
- Or … will changes be proposed of similar magnitude to the UK?

PPI Report (UK) - 2009

PPI findings:

- complex product and secondary purchase, typically bought with primary product (credit) → competition on primary product, not usually on secondary product
- Poor selling practices with information asymmetry → information not often available
- Large point of sale advantage and unclear that granting credit is not dependent on taking out PPI → consumers don't shop for cover
- High commissions, high profit margins and low claim costs
- Low customer benefits

Source: Competition Commission, *Briefing seminar on Draft PPI Order*, Adam Land and Charlotta Blomberg, 29 July 2009

PPI Report (UK) - 2009

PPI remedies:

1. Information Obligations

   Marketing Statement information, annual review notice, provision of claims ratios and "Personal" PPI Quote

2. Prohibitions

   a) Pre-sale: if reasonable grounds to believe consumer will make an application for credit, cannot conclude PPI sale for associated credit within 7 days of discussion
   b) Point-of-sale: cannot sell PPI to a consumer until 7 days after the later of- Credit Sale or provision of Personal PPI Quote. Exemption for consumer initiated transactions (phone or on-line) to 24 hrs after Credit Sale
   c) Single Premium prohibition: only monthly or annual premium business, with proportionate rebate on annual premium cancellations
   d) Requirement to offer unbundled PPI

ASIC Review

- ASIC is conducting a broader review of the sale of Consumer Credit Insurance (CCI) in Australia
- Concerns:
  - Sale of CCI without consumer consent or knowledge
  - Selling practices and scripting; with misleading or unclear information presented during sale and marketing offers
  - Use of tactics to induce consumers to purchase CCI
  - Illusory benefits: with sales made to ineligible consumers
  - Disclosure of insurance charges in credit schedules

ASIC Review

- Scope:
  - Sales practices of ADI's distributing CCI products to existing credit customers; including review of underwriting and claims data, with non ADI's to follow
- Outcomes will be discussed with ADI's and insurers and a summary public report **may** be published
- Author's view that changes to selling practices will ensue, without same level of prohibitions as seen in the UK Order

Insurer Response

What can insurers do in response to the regulatory review?

- Review of sales scripts for marketing and at point of sale, e.g. separation of credit activation and insurance sale
- Review of sales methods, esp. in far corners of the distribution spectrum
- Unbundling of product options to address illusory benefits
- Widening benefit eligibility criteria, e.g. unemployment
- Review of PEC exclusions and other clauses
- More sophisticated pricing with less community rating elements
- Migration of older series onto newer benefit designs ("waking the dead")
- Moving away from single premium products

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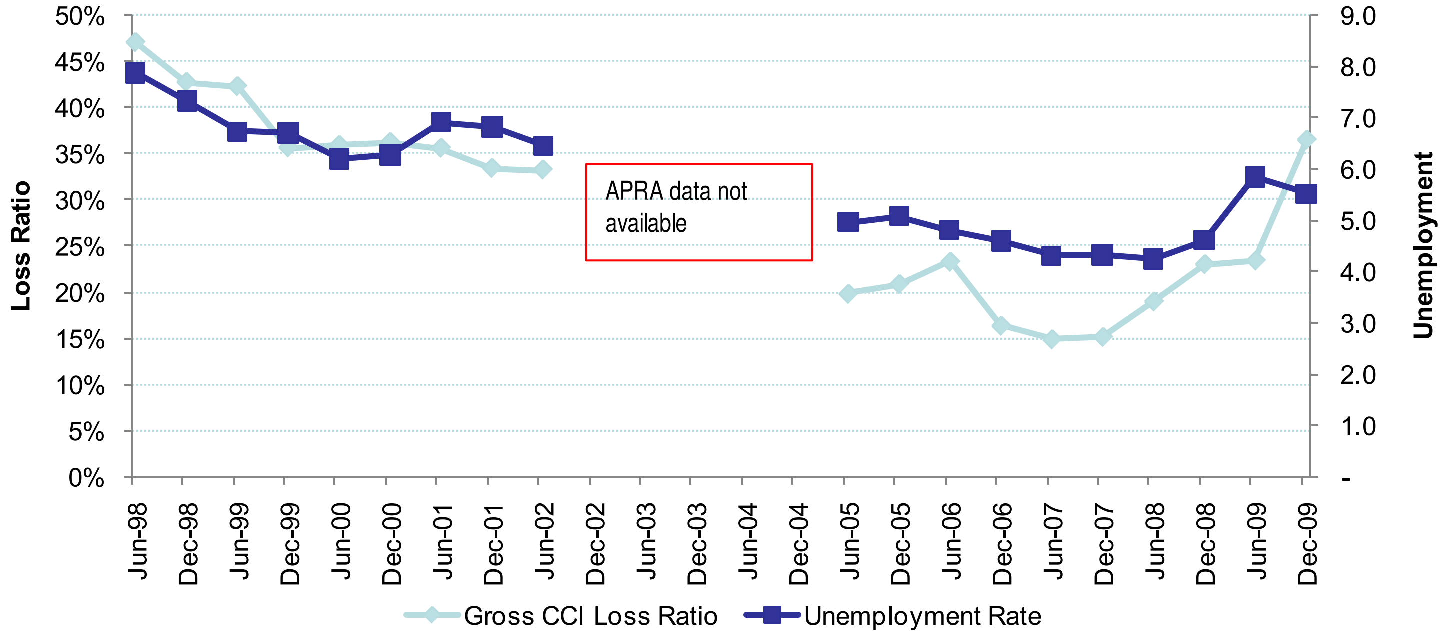
Loss Ratio Analysis – Industry Data



source : APRA statistics

- Industry loss ratio (by accounting period) is observed to be strongly correlated with the unemployment rate
- Relatively low loss ratio over the past 10 years compared to other classes of general insurance, partly reflecting the relatively favourable economic conditions

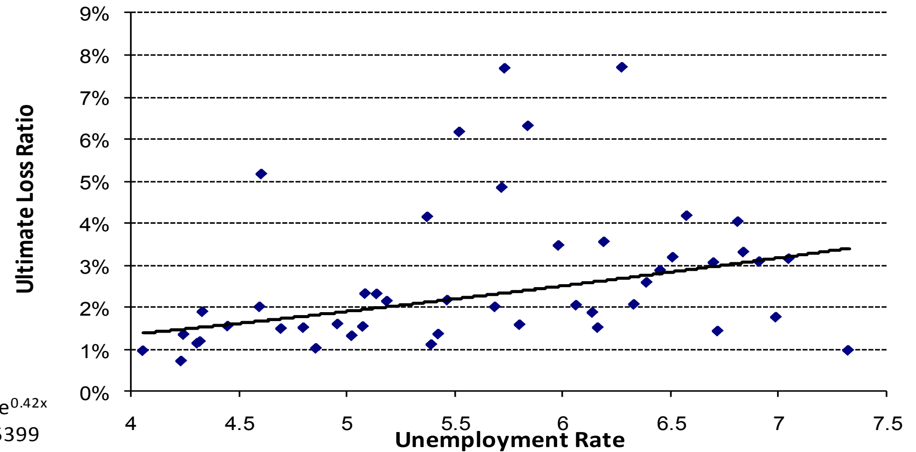
Loss Ratio Analysis – Sample Portfolio

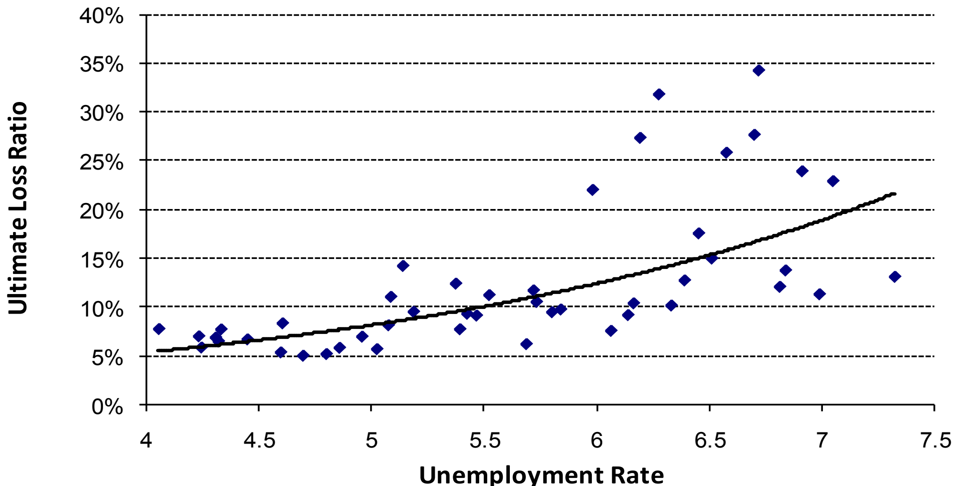
- Analysis of industry loss ratios by accounting period based on APRA data has several shortcomings:
  - Does not measure losses back to accident period
  - Loss ratios affected by provisioning changes for prior accident periods
  - Does not permit separate analysis by disability and unemployment
- In order to address shortcomings with APRA data, we have also analysed the loss ratio *by accident period* on an aggregated sample portfolio of various consumer credit insurance products:
  - Products within aggregated portfolio included credit card insurance, mortgage protection insurance and personal loan insurance
  - Unemployment and disability benefits were analysed separately
  - Utilised quarterly premium and claim data over a 12 year period to 2010
  - Claim payments were categorised according to “accident” quarter (being the quarter when the disability or unemployment event occurred)
  - A chain ladder method was used to forecast cumulative claim payments to ultimate for each accident period

Loss Ratio Analysis – Sample Portfolio

Best Fit Models:

Ultimate loss ratio on both unemployment and disability benefits are observed to increase (non linearly and at an accelerated rate) as the unemployment rate increases





Possible reasons why the loss ratio increases at an accelerated rate:

- Increased awareness of cover when it is really needed
- Increasing desperation to claim if prospects of re-employment look low

Loss Ratio Analysis – Sample Portfolio

- Comments:
  - Disability benefits are observed to have a surprisingly strong relationship with the unemployment rate (as evidenced by the relatively high R^2). Worth noting that R^2 on disability model is significantly higher than on unemployment model
  - Low R^2 for unemployment partly reflects that unemployment benefits are a small (and volatile) part of the loss ratio for CCI products. R^2 may also have been dragged down by a few outliers
  - Strong relationship between disability benefits and the unemployment rate suggests policyholders find a way to claim under disability benefits (often in preference to unemployment benefits) as the need arises

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Loss Ratio Analysis – Capital Implications

- Most difficult aspect of setting an appropriate level of capital for CCI business is in estimating the Probable Maximum Loss (PML) under a 1 in 250 year event → ***what is an "event" for CCI business?***
- Strong relationship between CCI claims and unemployment rate suggests that a catastrophic increase in the unemployment rate may be one way of defining an "event" for purposes of estimating a PML
- How would the CCI loss ratio respond as unemployment increases to very high levels?
  - → difficult to provide a "data driven" answer given the absence of any data points at higher levels of unemployment
  - → likely to see some continuation of the accelerating rate of increase in the loss ratio *up to a certain point*
  - – however, the loss ratio is likely to eventually flatten out, reflecting the effect of benefit limits and restrictions (affecting claim severity), as well as the likelihood of increased vigilance and investigative effort from claims managers (affecting both frequency and severity)
  - – the peak loss ratio for a particular product will depend on the benefit limits and restrictions for that product as well as the level of claim management focus

Loss Ratio Analysis – Capital Implications

CCI - Illustrative Loss Ratio Curves at High Unemployment Rates

Ultimate Loss Ratio (%)
200
180
160
140
120
100
80
60
40
20
0
3.5 5 6.5 8 9.5 11 12.5 14 15.5 17 18.5 20
Unemployment Rate (%)
Fitted Values
Predicted Values (flattening severity)
Predicted Values (flattening freq & severity)

Illustrative PML Calculation

- In order to estimate the PML, we also need to understand how long an “event” will last. i.e. how long will it take for the unemployment rate to return to normal levels following a catastrophic increase?
  - One possible approach is to assume a 3 year timeframe for events (in line with the approach used by APRA[1] in defining the PML for Lenders Mortgage Insurance (LMI), which is another class of business with loss experience heavily correlated with the unemployment rate).
  - Similar to LMI, losses may be spread over the 3 years in a “head and shoulder” pattern, with 50% of total losses in the second year, and 25% of losses in each of the first and third year

Illustrative Calculation:

Assumptions

- 3 year earned premium forecast (from business already written but unearned):
  yr1= $50m, yr2 = $40m, yr3 = $30m
- “peak” loss ratio (at very high unemployment rate levels) = 140%

Estimated PML = $50mx70% + $40mx140% + $30mx70% = $112m

1. Source: Attachment A, GPS 116