Household

ON SHAKY GROUND

With cracks beginning to show in the profitability of the household insurance market, is the sector set to crumble or are its foundations solid enough to see it through?

By Annie Makoff

While motor insurance has long been the loss leader in personal lines, there is a belief in the market that the household sector is set to experience its own slide into unprofitability.

According to market commentators, flood risk, opportunistic fraud and the increasing popularity of aggregators will all take their toll on insurers' bottom lines — despite Deloitte research published in December revealing the household insurance sector made a profit for the fifth consecutive year in 2012 (*www.postonline.co.uk/2232070*).

> "It's the consumer, and not the aggregator, who is leading the way in the household sector

"Statistics show although the sector was in profit in 2012, it was a decrease from 2011, so the sector is definitely on a downward trend," says Tom Moss, director of technical for Allianz Retail. "The market combined operating ratio was 89% in 2011, which worsened

to 94% in 2012 – that's getting close to being unprofitable."

Aggregators accused

Some insurers see aggregators as the reason for the slide. Price-comparison sites have surged in popularity in recent years, and expensive advertising campaigns and slick marketing have made Compare the Market, Money Supermarket, Confused and Go Compare household names.

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David Walker, chairman of the Avantia Group's consumer product Home Protect, believes aggregators have played a key role in repressing insurance margins but concedes they are "an inevitable part of life". He explains: "Aggregators are in all sectors of life now. We buy cheaper TVs because of price-comparison sites, so it's naïve of us to cry over spilt milk. A lot of businesses have done really well out of aggregators, but that does come with a price."

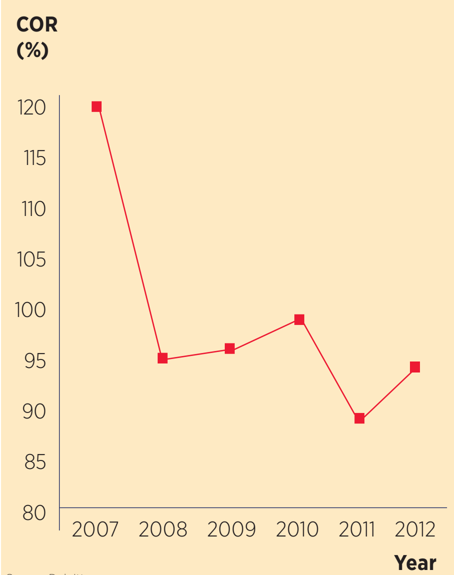
Walker believes that, as well as forcing insurers to lower prices, aggregators further hamper the profitability of insurers with their inability to cope with sufficient question sets. He explains: "How can you put together one common set of questions to cater for different circumstances and 86 different insurers? Aggregators just aren't able to tease out enough specific risk criteria to allow the insurer to rate sensibly.

"There will be gaps in information and sometimes, because an answer isn't mapped correctly, false information will be returned. That's not necessarily anyone's fault – it's just the averaging nature of aggregators – but it's an area that needs clearing up."

Indeed, the complex nature of household insurance and the level of detail required has stifled growth of the product in the aggregator space. In the early days of price comparison, the focus was on motor insurance. Those question sets, Moss explains, are relatively uncomplicated, and as consumers tend to shop around for new car insurance quotes each year, aggregators have a simple role to fulfil.

He adds: "However, with household insurance, many people have their policies tied up with their mortgages through their bank or building society. And as people are reluctant to move away from that arrangement, there tends to be a lot of inertia – which has made it more difficult for aggregators to break into the household sector."

Household insurance combined operating ratios



Source: Deloitte

John Dyke, managing director of UK personal lines at Zurich, agrees. "What is in your home is infinitely more important to you than the bent metal you drive around in. It's a much more emotive purchase."

Even so, the lure of aggregators in the household space is unlikely to fade any time soon, even if some firms believe consumers are better off dealing with insurers directly. David Jackson, distribution director at the Direct Group, says: "It's the consumer, and not the aggregator, who is leading the way in the household sector. Aggregators wouldn't work if nobody visited them."

Jackson, who worked previously at Compare the Market, believes aggregators are about convenience as well as price. "You can either visit 60 direct insurers' websites or go to one place and get them all. A lot of people underestimate the benefits of that convenience."

Gareth Lane, head of home insurance at Confused, argues aggregators benefit insurers as well as consumers: "Price comparison sites also offer low-cost acquisition models for insurance providers, especially smaller providers or those that operate in niche markets like non-standard home insurance."

Non-standard cover

However, many insurers believe aggregators are incapable of coping with non-standard home cover like flood risk, which was ▶ 22

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◀ 21 cited by the 2012 Deloitte research as a major area of concern for insurers.

Although the recent introduction of the government-backed Flood Re scheme – which guarantees households in high-risk flood areas affordable house insurance – hopes to improve the situation, it is likely to impact the profitability of the sector's insurers. Expected to be fully implemented by 2015 and financed by insurers as part of a not-for-profit fund, the scheme will see home insurance in high-risk areas capped. While government spending on flood defence will reach £370m by 2015-16.

However, Moss – who describes profit in the house insurance sector as "finely balanced" – is concerned that, regardless of the new flood arrangements, any major weather event would "tip the market into unprofitability". According to Moss, there is a tendency in the industry to take a short-term view, with insurers pricing according to recent weather patterns rather than looking long term.

He says: "You can't predict when there will be a major weather event. The last major flooding we had on a national basis was in 2007; in the aftermath, there seemed to be a fair amount of price increases to reflect the damage, but as time went on and the floods receded from people's memories, price increases were competed away as firms reduced their rates."

Get sophisticated

Walker believes more accurate risk pricing, led by a more sophisticated approach to underwriting, could be the difference between loss and profit – even if that means charging higher premiums. He uses the village of Cookham in Berkshire, which has always been prone to flooding, as an example. When a Cookham postcode is all that is used to price flood risk, houses at the top of a hill are put in the same bracket as houses elsewhere in the area that are much more vulnerable to flood damage.

"A number of insurers will count every house in Cookham as high flood risk, regardless of its proximity to the river and the likelihood of the individual property being susceptible to surface water flooding," he explains. "Actually, one-third of flood claims are due to surface water flooding."

However, Jackson argues: "The industry has become very sophisticated in fine-tuning exactly which properties are most at risk and insurers price according to that. At the same time, the larger insurers will want to continue to offer consumers affordable cover because they don't want to voluntarily price themselves out of the market."

For David Sweeney, director of commercial and personal lines at Sterling, the key issue in determining the impact of challenging underwriting factors like flood risk is about good risk selection, which feeds into better performance for the sector. "It's about having the conviction to say no when the market won't let you get the correct rate," he explains. "If you are selecting the right clients, carrying out the right background checks and getting the underwriting correct in the first place, you're not going to have an issue with undercharging for properties at risk of flooding, you're not going to have an issue with fraud and you're not going to have an issue with partially constructed buildings. And if the client is deemed too much of a risk, as an insurer, you just have to say no."

> " It's about having the conviction to say no when the market won't let you get the correct rate

Fraud, meanwhile, is also taking its toll on the sector – although experts agree it's yet to have a meaningful impact on the overall household COR. However, with household fraud more opportunistic, rather than the organised fraud in the motor space, it may play more of a part if the economic downturn continues.

Dyke says: "Although we're seeing less evidence of fraud in the household insurance space than we did during the 1990s recession, there are signs that it's increasing again, as people are more hard up and are trying to supplement their incomes."

Despite fraud not yet having a significant impact on the household space, insurers are still acutely aware of its existence, with exaggeration – where consumers make a claim for theft and exaggerate the value of the item stolen, or claim for additional items that haven't been taken – of particular concern.

Even so, while there appears to be disagreement among some experts as to the sector's overall profitability – and the impact of factors such as aggregators, flood risk, partially constructed buildings and fraudulent claims – there remains a consensus that it's unlikely to become a loss leader like motor insurance. Some commentators are confident the sector will remain profitable despite challenging underwriting factors and the growing threat of aggregators.

"Increased competition isn't necessarily a bad thing – it keeps us on our toes, and that's always going to be the case," Sweeney concludes. "But we have to be financially viable – it's in everyone's interest that we're profitable in the sector." ■

Tales from the archive: 2003

*While the household insurance sector is predicted to become unprofitable in the near future, the sector was facing similar scrutiny in 2003 as it looked to bounce back to profit following a string of weather-related losses (*www.postonline.co.uk/1222675*).*

Although underwriting results for UK household insurance have continued to "nosedive", Datamonitor has predicted the sector will return to profitability next year.

Based on current rate increases and assuming a lack of severe weather events, the market analyst said the industry's attempts to "claw its way back to profitability" should be realised in 2003. It added that there was evidence of drive for market share being overtaken by underwriting for profitability from the large household insurers.

Its research showed weather-related claims fell by 11.5% in 2001, mainly due to less damage caused by storm and flood incidents following a disastrous 2000, but burst pipe damage "exploded", with a 51.9% increase in costs to £339m.

Gross claims incurred in 2001 decreased 5.9%, but this was still 9% higher than 1999, according to Datamonitor. The increase in fire claims continued to outpace overall claims rises, growing by an average of 10.7% each year since 1996 and rising 11.2% over the 2000-2001 period, the analyst added. This is set against an overall average increase in claim costs of 3.8% year-on-year since 1996.