FAIR BY DESIGN
Ending the extra costs of being poor

CALL FOR EVIDENCE: THE GREAT RISK TRANSFER

MAY 2020

1. INTRODUCTION

Fair By Design welcomes the IFOA's call for evidence for The Great Risk Transfer campaign.

Please note that we consent to public disclosure of this response.

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2. ABOUT FAIR BY DESIGN

Fair by Design is a movement dedicated to reshaping essential services, like energy, credit and insurance, so they don't cost more if you're poor.

People in poverty pay more for a range of products including energy, through standard variable tariffs; credit, through pay day loans; and insurance, through post codes considered higher risk. This is known as the poverty premium.

We collaborate with industry, government, and regulators to design out the poverty premium.

Our Venture Fund provides capital to help grow new and scalable ventures that are innovating to make markets fairer.

Fair by Design was conceived by the Joseph Rowntree Foundation and Big Society Capital. The Barrow Cadbury Trust manages the Campaign, and Ascension Ventures manage the Venture Fund.

RESPONSE TO CALL FOR EVIDENCE

Q 1. Where and how do you see risks being transferred from institutions to individuals in the area(s) you work in, or in wider industry and society?

As a campaign, our main area of our concern is the poverty premium – the extra costs poor and low income people pay for essential services including credit, insurance and energy. Due to the link between low income and wider consumer vulnerability characteristics (see below) our response covers low income and the poverty premium, as well as wider consumer vulnerability characteristics. This is because consumer vulnerabilities are central elements when discussing the topic of transferring risk to individuals/consumers.

We have witnessed a large transfer of risk from businesses and government to individuals in the insurance market (as well as other markets such as pensions and savings). With reductions in welfare state provision, individuals are increasingly expected to look to the market to protect themselves and their families. This is a move to shift problems from a structural/system level, to an individual/behavioural level.

Examples of this transfer might include structuring the welfare state in such a way that a person is expected to work 'harder' to ensure self sufficiency and the ability to save (including pensions), along with self protection against income shocks via comprehensive private insurance products. However, what happens when a person is not able to work 'harder' due to health or caring responsibilities? What happens if a person cannot afford to move to a different neighbourhood which is deemed less risky? What happens if a person is not able to gain employment that provides a sufficient income? What happens when individuals are considered 'non-standard' or 'less desirable' by the market? This brings major problems when there is a move from a pooled risk approach to one of individualised risk.

People need access to insurance products that meet their needs at an affordable price. For this to happen the market needs to be able to accommodate the needs of people on low incomes and the characteristics that are often associated with low income – often referred to as consumer vulnerabilities.[1] However, a catch-22 situation has emerged where those who most often have the greatest need for protection are locked out due to:

- not being able to afford appropriate insurance because they are deemed to be a higher risk;
- not being able to access insurance that meets their needs because they are 'non-standard';
- being locked out of insurance altogether.[2]

There is a strong correlation between the detriment individuals face today and the shift away from pooled risk – from both the state (reduction of state safety nets) and the market.

[1] https://www.fca.org.uk/publication/occasional-papers/occasional-paper-8.pdf
[2] https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-17-access-financial-services-uk

Income shocks are the leading reason people get into problem debt. According to StepChange debt charity, 14 million people in Britain have experienced at least one income shock within a 12 month period; with 4.5 million people having experienced two or more.[3] Examples of income shock include losing a job, becoming seriously ill, getting divorced and bereavement. Millions of pounds are spent on debt advice, bankruptcy and debt write-offs as a result of income shocks. It would be better to tackle such issues upstream with affordable, appropriate protection available for all.

As a result of consumer segmentation in the insurance market, and insurance premiums reflecting (or attempting to reflect) the risk profile of individuals, the cost of insurance for low income and vulnerable consumers has gone up. As more risk is carried by the consumer rather than the insurer (or not pooled via cross-subsidisation) this has increased low income individuals' exposure to the poverty premium along with associated access issues.

Research carried out by NatCen Social Research found that one of the four main drivers of the poverty premium in insurance was cost-reflective pricing: insurance premiums can be higher for individuals living in low income areas, as these areas are considered riskier and are subject to a higher premium from the insurer.[4]

There are some protection products that are mandatory, such as car insurance. Recent research carried out for Fair By Design by the University of Bristol (yet to be published) found that in 2019, area-based premiums, particularly car insurance, were the largest contributor to the overall poverty premium faced by low income consumers. Customers who live in a higher-risk area (20th percentile Indices of Multiple Deprivation (IMD) area) paid nearly £300 per year more on average, if they had insurance, than those who lived in a lower-risk area (50th percentile IMD). In 2016, this figure was only £74, which shows a striking increase.

The risk transfer, to individuals from institutions, in reality means that low income consumers' "insurable needs" will either be limited to more expensive coverage (which may impact that consumer's financial health and/or ability to pay) or becomes so unaffordable that insurance becomes a lower priority. For example, research from the Joseph Rowntree Foundation found that low income households were less likely to have contents insurance, and that many of these households had previously had a policy but let it lapse due to financial constraints."[5] This may in turn lead to what WPI Economics has called the "latent poverty premium": where an uninsured item becomes lost or faulty, and needs replacing – which overall will cost the individual more than if they could afford to insure it. [6]

Data from the Association of British Insurers (ABI)[7] show how low income households are often exposed to greater risks. For example:

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[3] https://www.stepchange.org/Portals/0/documents/media/reports/StepChange%20Debt%20Charity%20New%20Normal%20report.pdf
[4] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/782513/natcen_report.pdf
[5] https://www.jrf.org.uk/sites/default/files/jrf/migrated/files/spr348.pdf
[6] https://www.barrowcadbury.org.uk/wp-content/uploads/2019/04/Insurance-and-the-poverty-premium-WPI-Economics-final.pdf
7 Helping Tenants Protect Their Possessions, Association of British Insurers (2010)

- Social–rented households are almost twice as likely to be burgled as owner–occupied households;
- Arson rates are 30 times higher in lower income communities than affluent ones;
- Low income households are 8 times more likely to be living in tidal floodplains than people in more affluent households.

Q 2. Are these transfers working in or against consumers' best interests, and why?

As stated above, because of the transfer of risk to individuals, and the impact that this has on the costs to insure, many lower income and vulnerable consumers (sometimes called non-standard consumers) are:

- not able to afford appropriate insurance as they are deemed to be a higher risk;
- not able to access insurance that meets their needs properly;
- locked out of insurance altogether.[8]

Those who may find themselves in such non-standard categories include:

- 9.4 million people aged 65 and over who may want to travel.
- Three million people with disabilities who have been turned down for insurance or charged extra.
- 2.5 million people living with or after cancer, forecast to rise to four million by 2030.
- Around 750,000 of the more than nine million people in the UK with a criminal record whose convictions are unspent. (People associated with others with unspent convictions can also be affected, for example, a parent being denied buildings insurance if their child, with an unspent conviction, moves into their house[9].)
- Customers who have made multiple claims within the last few years.
- Many low income households may also perceive themselves as non-standard when, for example, they reject mainstream home contents insurance policies as a poor match for their particular needs. [10]

Furthermore, the Financial Lives Survey, carried out by the Financial Conduct Authority, found that 39% of those with earnings up to £15,000 per year had contents insurance, compared with 75% of those with earnings between £50-70,000, and 71% of those with earnings between £30-50,000[11].

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[8] https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-17-access-financial-services-uk
[9] https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-17-access-financial-services-uk
[10] All figures gained from: https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-17-access-financial-services-uk
[11] Analysis based on the 2017 FCA survey (https://www.fca.org.uk/publications/research/understanding-financial-lives-uk-adults), detailed here: https://www.barrowcadbury.org.uk/wp-content/uploads/2019/04/Insurance-and-the-poverty-premium-WPI-Economics-final.pdf

A further analysis of the Financial Lives Survey, this time carried out by WPI Economics[12], found the following:

- 50% of households with car insurance and income of under £15,000 have breakdown insurance – compared to 59% earning between £15-30,000
- 39% of households with income of under £15,000 have contents insurance – compared to 59% earning between £15-30,000
- 5% of households with income of under £15,000 have mobile phone insurance – compared to 12% earning between £15-30,000.

While not directly related to risk pricing, it is worth mentioning some other factors that relate to higher overall costs for low income consumers:

Lack of switching

In some parts of the insurance industry, it is common to charge existing customers more for their insurance when they renew than new customers. While this won't solely affect low income consumers, this does explain part of the difference in cost as low income customers are less likely to switch (as was found to be the case across markets by Citizens Advice[13]).

The FCA also found that elderly and low income people were among the worst hit groups in terms of experiencing a loyalty penalty for not shopping around[14]. Combined, they are overpaying by £1.2bn in annual premiums because insurance firms are not providing the same level of deals to loyal customers. The FCA accused insurers of specifically targeting such loyal customers with big premium hikes in the knowledge they were less likely to switch.

Payment up front

Paying monthly rather than annually often comes with a premium, because monthly payments typically entail a credit agreement. Low income households are more likely not to have ready access to money to pay the full cost up front, and so need to spread their payments – and pay more.

Q 3. What do you think are the main drivers of this phenomenon?

As stated above, we have witnessed a transfer of risk from institutions, businesses and government to individuals in the insurance (along with many others) market. With withdrawals in welfare state provision individuals are increasingly expected to look to the market to protect themselves and their families. Customer segmentation and the

[12] https://www.barrowcadbury.org.uk/wp-content/uploads/2019/04/Insurance-and-the-poverty-premium-WPI-Economics-final.pdf
[13] https://www.citizensadvice.org.uk/Global/CitizensAdvice/Consumer%20publications/Super-complaint%20-%20Excessive%20prices%20for%20disengaged%20consumers%20(1).pdf) (p.24)
[14] https://www.theguardian.com/business/2019/oct/04/six-million-insurance-customers-hit-by-loyalty-penalty

movement away from collective pooling towards individualised risk pricing have driven up costs, as well as exacerbated access issues for low income and vulnerable consumers.

While this group of consumers has a real need for insurance (arguably more so than wealthier and less vulnerable consumers), many are:

- not able to afford appropriate insurance as they are deemed to be a higher risk;
- not able to access insurance that meets their needs properly;
- locked out of insurance altogether.[15]

We believe the main driver of this phenomenon is individualised pricing and a lack of a joined up approach between government and regulator to intervene. As observed by the authors of an FCA Occasional Paper on access to financial services, "as insurance moves further towards individualised risk-pricing, some people will pay lower premiums than they did as part of a larger pool. Others may see their premiums rise, be priced out of the market completely or even deemed uninsurable. In the face of increased segmentation, whether to protect consumers from high personalised insurance premiums and refusal of cover is often characterised as a social policy rather than a commercial decision".[16] This issue is compounded by a withdrawal of the welfare state and a lack of a joined up approach between government and the regulator to address the needs of those that struggle to gain access to affordable products that meet their needs.

Increased automation also plays a considerable role. As the FCA's Occasional Paper on access to financial services pointed out: "Insurers achieve economies of scale if they can funnel large numbers of customers through a standardised underwriting process, especially if it can be automated and delivered online. The mainstream insurance market conforms to this low-cost model which rules out the level of detail needed to cater for 'non-standard' risks. As a result, consumers with less common risk factors may find they are refused cover or quoted unusually high premiums when they search on comparison websites, because their non-standard circumstances are outside the parameters of the automated algorithm."[17]

The availability of Big Data has made the transfer to individualised risk pricing easier for insurers. But, as evidenced above, this has shifted pressure onto particular groups of consumers, in particular those on low incomes and in vulnerable circumstances.

The FCA has previously stated its concerns over the potential of big data to increase risk segmentation and consequently lead to consumers with higher risks being unable to obtain affordable insurance. The Financial Services Consumer Panel has also described this process as an "increasing demutualisation of risk" and has called on the FCA to assess the risk models used by firms, to ensure they are treating customers fairly.[18]

[15] https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-17-access-financial-services-uk
[16] https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-17-access-financial-services-uk
[17] https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-17-access-financial-services-uk
[18] https://www.financialinclusioncommission.org.uk/pdfs/improving_access_to_household_insurance.pdf

When the Financial Inclusion Commission looked at the consequences of increased segmentation it found[19]:

- Firms, operating low cost bases, are able to offer low premiums, only to 'standard risk' consumers.
- This leads to reduced prices for those who fit within the product parameters, and increased prices for those consumers that don't fit.
- More differential pricing means fewer cross–subsidies/less pooling of risk.
- Some consumers are therefore priced out of the market and living with no cover.
- Others are having to restart the process offline i.e. by telephone or email, because the online application has not given an explanation for the quote, or lack thereof.
- An increased focus on price as the point of comparison for consumers, at the expense of other factors such as coverage – increasing the likelihood of purchasing an inappropriate product that does not meet or reflect their needs.
- Pressure on insurance providers to focus on cost at the expense of other factors, in order to win business.

As a result, consumers who are deemed by insurance companies to be high risk or 'non standard' may find few options open to them. As the Financial Inclusion Commission points out, this may become apparent "only after a lengthy, sometimes distressing, search." The Commission continues: "If they can find products, these consumers may end up paying a high price for a product that doesn't fully meet their needs, choose to go without cover or even fail to disclose their circumstances fully with the risk that any subsequent claims may not be paid. What is clear that there is a supply gap for consumers who want to purchase cover find they are categorised as 'non standard' risk. This leads to a coverage gap for those who should have cover but don't."[20]

Q 4. Which consumer groups are benefitting and which are being negatively affected by this risk transfer? How are these groups being affected?

Vulnerable and low income consumers are being negatively affected by the risk transfer.

There are a number of factors that act as drivers to actual or potential vulnerability, for example, as described by the FCA in their consultation on consumer vulnerability guidance[21]:

- Health – health conditions or illnesses.
- Life events – major life events such as bereavement or relationship breakdown (includes income shocks).
- Resilience – low ability to withstand financial or emotional shocks.
- Capability – low knowledge of financial matters or low confidence in managing money.

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[19] https://www.financialinclusioncommission.org.uk/pdfs/improving_access_to_household_insurance.pdf
[20] https://www.financialinclusioncommission.org.uk/pdfs/improving_access_to_household_insurance.pdf
[21] https://www.fca.org.uk/publications/guidance-consultations/gc19-3-guidance-firms-fair-treatment-vulnerable-customers

These categories are not meant to be definitive or exhaustive in nature. However, they are a useful illustration of the permanent and transient nature of consumer vulnerability. See table below for further examples from the FCA[22].

Health	Life events	Resilience	Capability
Physical disability	Caring responsibilities	Low or erratic income	Low knowledge or confidence in managing financial matters
Severe or long-term illness	Bereavement	Over indebtedness	Poor literacy or numeracy skills
Hearing or visual impairments	Income shock	Low savings	Low English language skills
Poor mental health	Relationship breakdown	Low emotional resilience	Poor or non-existent digital skills
Low mental capacity or cognitive disabilities	Having non-standard requirements such as ex-offenders, care leavers, refugees	Lack of support structure	Learning impairments

In addition, vulnerable and lower income consumers are disproportionately affected by underwriting methods. This could be due to the way insurers price risk based on the area where people live (with more deprived areas incurring higher premiums); or because insurance underwriting models penalise certain characteristics such as those with 'non-standard' needs (e.g. higher costs due to adapted cars or high-value items to make homes accessible) or due to characteristics such as pre-existing health conditions.

The FCA, in its interim report on general insurance pricing practices, did acknowledge that underwriting methods have put certain customers, especially vulnerable consumers, at a disadvantage.[23] Additionally, the FCA, in its vulnerability guidance consultation[24], recognised low and erratic income, as well as general financial resilience, as key drivers of vulnerability.

Furthermore, we know that many consumers find information about financial products complex, too confusing, or are time-poor to such a degree that relying on information impedes their ability to make good decisions. This is especially the case for more vulnerable consumers, including those on low incomes. [25]

Instead of placing the onus on consumers to make the 'right' purchasing decisions, we believe there needs to be more focus on regulator and firms' actions, such as observing inclusive design principles – where regulators must design markets and firms must design products and services that consider all consumers. Instead of making the consumer fit the product, businesses (via regulatory rules and guidance) should shape products to serve

[22] https://www.fca.org.uk/publications/guidance-consultations/gc19-3-guidance-firms-fair-treatment-vulnerable-customers
[23] https://www.fca.org.uk/publication/market-studies/ms18-1-2-interim-report.pdf (paragraph 4.21)
[24] https://www.fca.org.uk/publications/guidance-consultations/gc19-3-guidance-firms-fair-treatment-vulnerable-customers
[25] https://www.fca.org.uk/publications/occasional-papers/occasional-paper-no-8-consumer-vulnerability

consumers in ways that reflect their lives. We believe that many of the problems faced by low income, excluded and vulnerable consumers could be addressed by inclusive product and service design. There is too much reliance on trying to fix problems later via customer service/support.[26]

Q 5. Are there any examples of regulatory or policy interventions which are either supporting consumers to maximise the opportunities afforded by choice, or helping to tackle the potential adverse impacts?

Fair By Design has a venture fund that invests in new products designed to address the poverty premium faced by low income consumers (see: https://fairbydesign.com/fair-by-design-fund/). At the time of writing this fund has not been able to find any insurance initiatives suitable for investment, which points to the need for social and regulatory policy intervention in the market.

As the FCA's role includes consideration of systemic risks, it should also consider requirements on industry to use data in a way that promotes better outcomes for consumers. **We believe the FCA should work closely with government and insurance suppliers in a joined up approach to ensure that consumer needs don't fall in to the 'black hole' that exists between market and social policy.**

Flood Re was created to address the needs of people living on flood plains and provides a useful example of where social policy can override the commercial insurance principle. If low income consumers present higher risk for insurers (e.g. living in areas susceptible to crime) a system akin to Flood Re could be developed. When the cost of the risk (burglary, etc.) climbs above a certain level, the insurer could place that part of the policy into a pooled fund where, in the event of a customer making a claim, the insurer will then be able to recover the costs associated with a pay out.

Finally, WPI Economics[27] proposed a range of options to increase low income consumers' access to insurance:

- **A basic/simple insurance product**: this could reduce costs, as well as overcoming issues around trust in financial services.
- **Regulation to eliminate the monthly payment premium**: this would prevent low income households with little immediate access to funds from being charged more for needing to spread their payments.
- **Auto-enrolment (opt out) through home rental contracts**: particularly for local authority or housing association tenants, this could 'nudge' more low income households to take out contents insurance (via low cost group schemes).

[26] https://fairbydesign.com/news/inclusive-design-in-essential-services/
[27] https://www.barrowcadbury.org.uk/wp-content/uploads/2019/04/Insurance-and-the-poverty-premium-WPI-Economics-final.pdf

- **With present deficiencies in state safety nets, auto-enrolment through Universal Credit**: a single provider of insurance for Universal Credit claimants could benefit from economies of scale and reach large numbers of low income households. This would need to be paid by the state rather than individuals.
- **Incentives to business to offer insurance as a staff benefit**: businesses already provide employees with pensions (through auto-enrolment), but many also provide additional benefits as part of an employment package (such as occupational sick pay). Larger employers in particular could provide access to affordable insurance, pooled among employees.

Q 6. What are the current barriers to interventions in this area and how might they be overcome?

There are a number of contributory factors, including:

- **A lack of a joined up approach between the regulator and government on who owns the UK's under-insurance problem and how it should be addressed.**
- **A lack of appetite to bridge social and regulatory policy by both the regulator and government so adequate interventions can be put in place.**
- The opacity of mainstream insurers' risk models is a significant barrier to intervention (more detail below).
- An emphasis by the FCA on signposting and consumer education rather than addressing the underlying issues of fairness and access for low income and consumers in vulnerable consumers.[28]
- Lack of resource at the Equality and Human Rights Commission to investigate whether the insurance industry is treating people with protected characteristics, such as disability, fairly in line with the Equality Act. Plus, the lack of a statutory gateway to enable the FCA to share confidential information with the EHRC.[29]
- Lack of inclusive design approaches to policy making and necessary interventions at the FCA.[30]

As the risk modelling of insurance firms is commercially sensitive and often private, the FCA should consider a new standard for how data, including non-financial data and Open Finance data, can be used in calculating insurance premiums. The standard should also provide guidance on explaining, wherever possible, to a consumer why they are charged the price they are for insurance. This would also allow consumer advocates to better understand risk modelling so they can take action to address issues the market alone cannot deliver for low income and vulnerable consumers.

[28] https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/2423/242302.htm
[29] https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/2423/242302.htm
[30] https://fairbydesign.com/news/inclusive-design-in-essential-services/

Increased transparency would be an important first step to reducing the barriers to effective intervention. The Financial Inclusion Commission found an apparent lack of transparency in the underwriting process.[31] The Commission notes a proposed solution: that industry is required to be as transparent in all areas of its underwriting as it is currently required when considering age and disability (because of exemptions under the Equality Act).

It is worth noting that a lack of transparency is also a major issue for consumer organisations. As the FCA's Occasional Paper on access to financial services states, given the opacity about the way insurers determine risk-based prices, "it is impossible for consumers or the bodies that represent them to know whether the pricing is fair. The ABI/BIBA non-statutory agreement with the Government … commits the industry to increased transparency by requiring the ABI to publish annually data on how age affects risk and premiums […] While there are no plans to extend this initiative, similar data for other areas of insurance (for example, the correlation between different types of disability, claims and premiums) would improve transparency and trust among consumers (and their representative organisations). They would also provide the opportunity for outside scrutiny to ensure that insurance decisions are based on the most relevant and accurate information."[32]

Above all, we would like to see:

- **a joined up approach between the regulator and government on who owns the problems in this area and how the problems should be addressed.**
- **action to bridge social and regulatory policy by both the regulator and government so adequate interventions can be put in place.**

[31] https://www.financialinclusioncommission.org.uk/pdfs/improving_access_to_household_insurance.pdf
[32] https://www.fca.org.uk/publication/occasional-papers/occasional-paper-17.pdf