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Liberalisation of Motor Insurance Business: Rewarding Good Risk Management

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Highlights

- The liberalisation of motor insurance achieves more equitable pricing which reflects the underlying risks and appropriately differentiates good and bad risks.
- Broader rating factors will be taken into account in determining fairer premiums for consumers.
- Consumers will benefit from healthy competition which will lead to improvements in service quality, expanded range of products and continued access to motor insurance cover at competitive prices.

What is motor insurance liberalisation?

Liberalisation of motor insurance means that the price, scope of coverage and terms and conditions of motor insurance products will no longer be dictated by the Motor Tariff which until 2012, was last reviewed in 1978. Under the new environment, the pricing of motor insurance products will be determined by individual insurers based on risk factors and competitive forces. Products and pricing will no longer be standardised and may vary from one insurer to another. This allows motor insurance providers to be more responsive to consumer preferences and market conditions. It also achieves more equitable pricing which better reflects the underlying risks and appropriately differentiates between good and bad risks. Consumers with good risk profiles should expect better pricing for their insurance premiums.

The liberalisation process is carried out in two phases. Phase 1 which was implemented on 1 July 2016 saw some insurers introducing new motor insurance products with non-tariff features, at market rates. Under Phase 2, which began on 1 July 2017, two existing motor insurance products covered by the tariff were liberalised. These are:

(i) products that provide coverage for third party losses and loss or damage to an insured's own vehicle due to fire or theft only; and

[1] This article is an extension to the Box Article on 'Assessing Demand-Supply Conditions in the Malaysian Property Market', in Bank Negara Malaysia's Annual Report 2015.

(ii) products that provide comprehensive coverage, comprising coverage as per (i) above as well as damage to an insured's own vehicle from any accident.

Compulsory third party insurance required under the Road Transport Act will remain controlled under the tariff. This aims to ensure continued affordable access to compulsory motor insurance during the transition and facilitate gradual and orderly market adjustments. Further liberalisation will be subject to a review by Bank Negara Malaysia in 2019 to assess the readiness of the market to support subsequent phases of liberalisation.

Addressing pricing inequity and incentive problems under a tariff environment

Under the tariff arrangement, significant cross-subsidies exist between risk segments resulting in some policyholders paying more premiums than they should, compared to relatively riskier drivers and vehicles. Beyond a certain point, broad-based adjustments to tariff rates which increase the extent of cross subsidies would lead to sub-optimal outcomes. Insurance would become economically inefficient for good risks, resulting in adverse selection and reduced capacity for motor insurance among insurance providers.

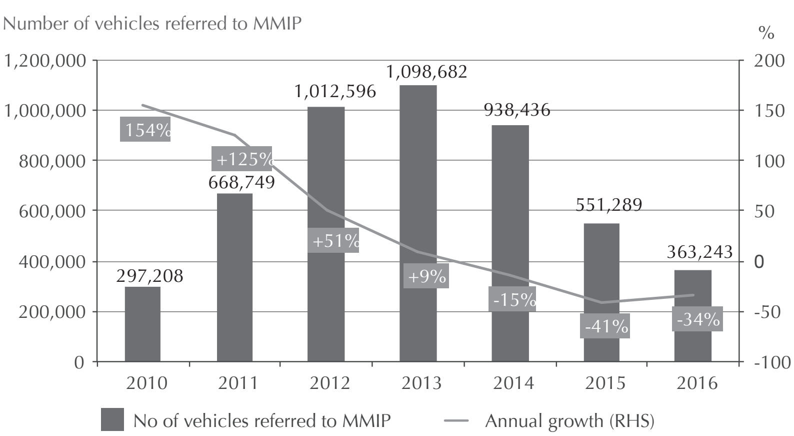
Evidence of this was observed in 2012 when over a million private vehicles had to turn to the Malaysian Motor Insurance Pool (MMIP) to obtain motor insurance cover following actions by several insurers to decline motor (especially third party) risks due to prolonged and sustained losses. Risks in the pool were subjected to significant premium increases at the time. Underwriting conditions subsequently eased with gradual tariff premium adjustments introduced under the New Motor Cover Framework in 2012. The adjustments fully anticipated an eventual transition to a more sustainable, market-based pricing environment in order to reduce the distortions mentioned earlier.

Between 2011 and 2016, the insurance industry also paid out more than RM2.8 billion in claims for losses from vehicle theft. Despite a disproportionately higher incidence of theft observed for specific vehicle models, insurers were unable to differentiate pricing accordingly under a tariff environment and this led to increased pressure on overall premiums.

These developments illustrate the problems associated with a tariff system in which weak incentives exist for vehicle owners, manufacturers and drivers to manage risks. This in turn leads to higher premiums over time which are not properly attributed to and borne by those risks that contribute most to losses. The lack of competition between insurers also weakens the functioning of market mechanisms that allow optimal prices to emerge, and impedes innovation and service quality improvements which ultimately benefit consumers.

Chart 1

The Small Premium Adjustments had Partially Resulted in Some Insurers Accepting Motor Risks Previously Declined Due to Misaligned Pricing



Source: Malaysian Motor Insurance Pool (MMIP)

How premiums are calculated and early observations of premium trends in the liberalised environment

Insurance is based on a pooling concept where similar risks are pooled together. In a liberalised environment, similar risks can be grouped together in more granular pools, thus allowing prices to more accurately reflect the risks presented.

More factors will also be taken into account in determining premiums. Under the tariff, premiums were largely driven by sum insured, cubic capacity of the vehicle engine, age of driver and age of vehicle. While these factors remain relevant in the liberalised environment, premiums may also be further differentiated based on other additional factors such as vehicle make and model, security features in the vehicle, driving experience and behaviour, duration the vehicle is on the road, location of a vehicle when not in use and record of traffic offences. The factors that drive pricing will vary between insurers.

Based on pricing models of 11 out of 26 insurers sampled by Bank Negara Malaysia as at end July 2017:

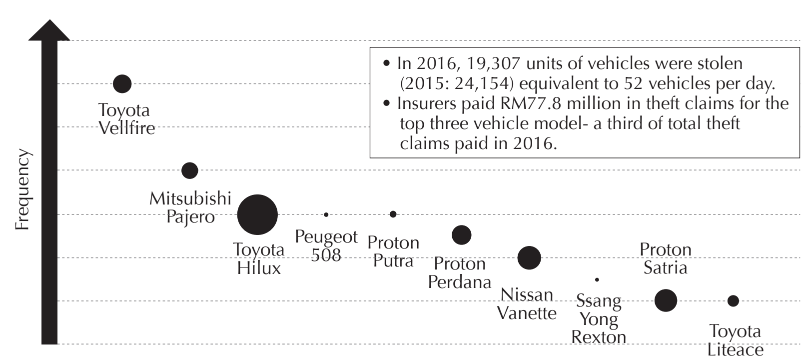
- Both premium increases and decreases within a range of +/-10% were observed across all risk pools. This suggests insurers are appropriately differentiating between lower and higher risks consistent with more equitable pricing.
- A reasonable dispersion of premium adjustments that were less than +10% was observed, suggestive of more refined pricing models by some insurers.
- Premiums generally decline with age, reflecting higher risks associated with younger and less experienced drivers, in particular below the age of 25 years. Some policyholders within the age band of 40 and 50 years old may experience marginally higher premiums, which is partly attributed to the use of their vehicles by young adult children of driving age.
- Downward adjustments in premiums were more prevalent for newer cars compared to older cars.
- No significant differences were observed across vehicle makes and models which may indicate a more cautious approach taken by insurers before fully reflecting risk factors in price adjustments. In the initial phase of liberalisation, this is likely to tamper the effects of premium adjustments across risk groups. An exception, however, was observed for high theft-prone vehicles which are likely to attract higher premiums.
- Higher premiums were observed for vehicles in West Malaysia than those in Sabah and Sarawak. This is mainly due to differences in risk levels and risk exposure arising from traffic density and road conditions.

These observations do not take into account more specific individual risk factors that insurers may apply in calculating premiums for individual policies. An insurer can apply such additional factors (for example, how often a vehicle is used or security features installed by a vehicle owner) to adjust premiums either higher or lower than that indicated by their pricing models.

Chart 2

Higher Incidence of Theft is Observed for Specific Vehicle Models in Malaysia

Top 10 frequently stolen vehicles in 2016



Note:
1. The size of the bubble represents the number of theft count for each vehicle model
2. Frequency is calculated by dividing the number of theft count by total policy count
Source: Vehicle Theft Reduction Council

Consumers should therefore make comparisons of products in terms of features, premium rates and scope of protection, to select the product that best suits their needs. Consumers should also be mindful that price should not be the only determining factor when purchasing coverage. Insurers' customer service standards and claims handling are other important considerations in deciding which product to buy and which insurer to buy from.

More choice and control for consumers

With liberalisation, a wider range of product options is being offered by insurers to suit different needs. Telematics insurance is one such product. It takes into account the extent of use of vehicles and driving behaviour in determining premiums, where drivers can enjoy premium discounts for vehicles that are used less often or if safer driving behaviour is observed.

With greater flexibility in product design, policyholders can also choose different levels of coverage for the perils that best suit their risk exposure instead of standardised perils under the tariff, thus having more control over the extent of coverage and hence, premiums that they will ultimately pay. Consumers can also take practical measures to influence the premiums that they pay, for example parking in secure facilities when not in use, installing anti-theft devices or considering vehicle specifications that can reduce insurance risk when buying a car.

As insurers will offer different product options and flexibilities, it is important that consumers shop around. Information on motor insurance and takaful providers, product options, and convenient on-line channels to obtain premium quotations from insurers is available through the 'product selector' provided at Persatuan Insurans Am Malaysia's (PIAM) and Malaysian Takaful Association's (MTA) websites. Alternatively, consumers can go to the websites of individual insurers directly, or through Bank Negara Malaysia's website, for information and quotes.

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