OLIVER WYMAN

Financial Services

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INTRODUCTION

In conjunction with Swiss Re's 150 years anniversary, for this edition I had the pleasure to speak with Christian Mumenthaler, CEO Reinsurance at Swiss Re, to discuss their history and shaping of the future.

Our other articles in this edition: conduct risk, managing volatility, growth, future of life insurance in France also cover important regulatory implications, finance & risk and strategy topics as well as the intersection between these areas. These topics address only a few of the many challenges insurers face today.

Amongst all of them, I consider 'growth' to become the dominant priority which should again move up the insurers' boardroom agenda. In real terms, we have experienced stagnation or even decline in many markets and business lines. Many insurers are stuck in a continuous cycle of cost efficiency programmes and struggle to find their way back onto a growth trajectory. Having assessed the levers for growth in the mature markets, we are bullish at Oliver Wyman that insurers can – and should – return to an active growth path with the aim to achieve at least real GDP growth (or alternatively inflation plus average productivity gain). In recent months, we have been working with many of our clients to help them shape innovative growth strategies and renew entrepreneurial thinking, in order to develop new technology, partnerships, value chain and operational design.

I hope you will find this edition of the newsletter an interesting read and would welcome your comments.

You can also download previous editions of our insurance CEO conversations on http://www.oliverwyman.com/ceo-conversations.html

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A CONVERSATION WITH

CHRISTIAN MUMENTHALER

CEO REINSURANCE, SWISS RE

Interview conducted by Bernhard Kotanko, Partner, Head of EMEA Insurance Practice, Oliver Wyman

OLIVER WYMAN: *Christian, thank you for taking the time to speak with us today about the Swiss Re strategy and some of your personal experiences in developing the organisation and talent in Swiss Re. Swiss Re has made a remarkable comeback after the crisis. What do you think was the key to this?*

CHRISTIAN MUMENTHALER: Obviously, the crisis was a very difficult time for Swiss Re. A key element for our comeback has been that the clients and brokers stayed with us. We received a lot of emails at the time that said that we had seen other difficult times together and that we would go through this together. This then becomes a self-fulfilling prophecy. Having your clients stay with you creates an upward spiral with other stakeholders, such as regulators, governments, employees, market participants. Another reason is that, probably, the situation was not as bad as perceived. There was clearly a negative perception about our asset side. But we held onto them and they recovered in value. The assets were not as bad as some people thought and this also helped a lot on the capital side afterwards. Finally, we have some 150 year-old relationships. Some of the claims we pay are on contracts that are 60 years old. No one has an interest in letting a firm like Swiss Re go down. We are a strong systemic stabiliser.

"A key element for our comeback has been that the clients and brokers stayed with us. We received a lot of emails at the time that said that we had seen other difficult times together and that we would go through this together."

Looking into the future, you gave a lot of room to emerging markets in your strategy. What are your initial learnings from this push, especially in current turbulent times?

Swiss Re has been in some of these markets for an eternity. We celebrated 100 years in Brazil. Imagine our people going in steamboats to do business in Brazil at that time! So, we have always been doing business in emerging markets. Some of these countries are at early stages in their economic development and they have particular needs. They have less data and often need specific IC. They have a younger working population

and in some cases the political context is less stable. The challenge for a large organisation like Swiss Re is to recognise these differences and act accordingly to capture opportunities from these high growth markets. In crisis situations firms typically retreat from these markets first. They react to the volatility in a way that becomes pro-cyclical. We try to take a longer-term view with a sustainable investment plan the whole management team is committed to. We have made sure that two executives are responsible for each market: the person directly responsible for it and one other member of the management team. This ensures broad understanding and commitment up to the top team.

Client proximity is another theme Swiss Re has been pushing hard. How do you as CEO of Reinsurance include client proximity in your agenda?

Swiss Re is an analytical organisation built on underwriting knowledge. As such, we can become quite technical, university-like. To me, it was important to become more of a client-oriented firm – to put our clients in the centre of our thinking and our expertise. Clients are the reason for our existence and the source of all our value. So pushing the organisation towards client-centricity is not too hard. The organisation knew that this is the right thing to do and we heavily communicated our client focus. We also measure client focus and everyone has to write discussion notes about every client visit, all the way to the top management. We lead by example and publish our results every month. I gave myself a goal of seeing 100 clients a year – documented, not just shaking hands. This transparency reminds us every day of our clients. We also track Net Promoter Scores – and they are improving! We treat every critical feedback seriously with top management attention. Overall, we are very passionate about our clients and the service we provide.

"I gave myself a goal of seeing 100 clients a year – documented, not just shaking hands. This transparency reminds us every day of our clients."

You did some strategic moves along the value chain, for example, with the Corporate Solutions business and the FWD acquisition in Asia. Do you see a convergence between primary and reinsurance?

I see no convergence of the value chain between reinsurance and primary insurance. These remain adjacent but separate businesses. Reinsurers' advantage is their technical excellence and their balance sheet strength. Primaries are more about distribution, brand, product design and efficient scale administration. There are no strict borderlines and, in pockets, like large commercial risks, there is a natural grey zone and some insurers seek our enlarged contributions. At the same time, primary insurers retain more risks on their balance sheets. At Swiss Re, we manage these businesses completely separately and strictly firewalled. This avoids any possible conflicts of interest.

Moving from strategy to organisation. Swiss Re is a large global corporation. How do you maintain agility and entrepreneurial teamwork across units, divisions and markets?

For any large organisation it is necessary by definition to have more protocols and it is simply not viable to be as agile and entrepreneurial as a start-up. And this would also be a wrong expectation because you need different values to run a large corporation over 150 years. Nevertheless, maintaining the right degree of entrepreneurial spirit and agility is important. We achieve this by keeping movement in the organisation, not in the structure, but in the people: changing roles, combining the right mix of profiles, mixing internal with some external talent. Also, we encourage thinking and speaking openly and directly as well as taking ownership. All this combined keeps people motivated and fresh.

> *"We encourage thinking and speaking openly and directly as well as taking ownership. All this combined keeps people motivated and fresh."*

In setting up Swiss Re's reinsurance division you had the chance to shape a new, young leadership team. What were your guiding principles in this organisational design?

I am passionate about teams and had the privilege of shaping our reinsurance team. It combines a half of long-term Swiss Re employees, a quarter of employees that joined us through the GE Insurance Solutions acquisition, because we appreciate the set of values and capabilities they generally have, especially in operations, process and communication, and then a quarter from different external career backgrounds who contribute unique perspectives. To foster client centricity half of our main sales organisations are led by people who come from primary insurers. Finally, we have people in the team with a background in banks that went through challenging times and bring the right edginess. Looking at the cultural mix, we combine a minority of Swiss nationals with many other backgrounds. Finally, in working together as a team we also look at mixing different styles in communication and personalities. All this diversity makes it a powerful team.

More generally, how does Swiss Re attract and develop talent?

I think you need passion and time to attract and develop the right people and we invest a lot of time on it at Swiss Re. Developing talent is a bigger topic than attracting it. We put a lot of effort into discussing career paths for our future leaders. One aspect, as mentioned earlier, is growing into new roles. I think that every five years a manager should get new opportunities. It is vital to find the right match at the right time. To do so you need to know your talent very well. Managing talent likely takes up a third of my time.

Swiss Re stands out as a knowledge-based company. How do you nurture this asset of knowledge in your organisation?

We are in a time when capital is increasingly a commodity. But knowledge differentiates us and drives our value for clients. This is part of our DNA and our natural inclination is to build and utilise knowledge. To achieve this comes back to the talent topic. With the right set of people we can foster a truly knowledge-based culture.

A few months ago you changed the organisation of your life insurance business. And, at least from the outside, it was a smooth transition. What were your tactics in making it a smooth process? And what did you learn?

First, as much as I am passionate about moving people, I dislike reorganisations because they always have a cost, especially in terms of distracting people. We should only do them if there is a clear business case. Speaking about life reinsurance, last year it became clear that some of the challenges we have in our life and health reinsurance book could be tackled better if there was an in-force division. This division should look at our in-force in a comprehensive way that brings together the full value chain for it: actuarial, claims, accounting, reserving. For example, there is value to be created from lowering lapse rates for our clients. We did the reorganisation starting from the top. It was a good opportunity for our people to take on new roles. We then followed a cascade of actions combined with transparent and intensive communication. The context was positive because this was not about cost cutting, so there was little anxiety in the organisation. Our people bought into the reason for making the change and they liked the clear missions. So the energy started to flow quickly and this made it a smooth change.

> *“You need passion and time to attract and develop the right people and we invest a lot of time on it at Swiss Re. Developing talent is a bigger topic than attracting it.”*

> “In such a global organisation with so many new things all the time, you need curiosity and you need humility.”

You lead a very diverse organisation. What have been your personal learnings from that?

Swiss Re is a very global, multifaceted organisation which I was excited about from day one. During my career at Swiss Re I have worked in many different places and got to know nearly every function at least indirectly. In such a global organisation with so many new things all the time, you need curiosity and you need humility.

Swiss Re celebrated its 150th birthday. How does the firm's long past inform your thinking about its future?

The 150th anniversary is a great opportunity for reflection. When you look back you can see the incredible energy that was there in the beginning of our firm. It was a high risk venture: two people starting in a two-room apartment in the middle of Zurich with one contract. Since then, Swiss Re has gone through enormous historic challenges: world wars, hyper-inflation, currency devaluations, change of states, great recessions. Swiss Re weathered all these storms and I believe that part of the company's DNA is the ability to survive such unplanned shocks. One lesson from history is that it would be a huge mistake to expect the future to be smooth. There will be more significant turbulence, as there has been in the last 150 years and it is impossible to say where and when it will come. So we build resilience: the right culture, the right people – and, obviously, we have the capital strength to survive such shocks.

Many thanks for this discussion and all the best for the next 150 years of Swiss Re.

THE RULES ARE NOT ENOUGH

Conduct Risk for Insurers

OLIVER WYMAN

CII

Executive summary

Conduct regulation, affecting how insurers treat their customers, has become a matter of strategic importance for insurance. As we saw at the end of March, a single regulatory announcement by the UK's Financial Conduct Authority (FCA) – that had already been trailed to the industry and its trade body – can trigger a violent reaction and instantly wipe billions of pounds off the value of insurers.

Yet, while many of the actions taken by the FCA have been predictable rather than surprising, recent research by Oliver Wyman and the Chartered Institute for Insurers (CII) shows a continued mismatch of expectations between insurers and the FCA on the extent of change required to address consumer protection issues. We have also identified emerging risks that could significantly affect current insurance business practices.

Core to the FCA's supervisory activity is the question "does the firm have the interests of its customers and the integrity of the market at the heart of how the business is run?" In pursuing this, Martin Wheatley, FCA Chief Executive has already shown that the FCA will be "a very different animal to the Financial Services Authority". And regardless of the inquiry into the FCA's handling of the announcement that it was to investigate legacy life and pension products, the bigger picture is not going to change.

In conjunction with the CII, Oliver Wyman conducted research to understand the views of insurance leaders to the FCA's conduct risk agenda. This article summarises the findings from 'Conduct Risk for Insurers: Responding to a Fundamental Shift in Regulatory Expectations', a report published by Oliver Wyman and the CII earlier this year.

Mismatch in expectations

Our interviews revealed that, for some firms at least, a shift to a more transparent and competitive market The FCA has been active in setting out its views on perceived deficiencies within the insurance market and its activity in its first year, plus its recently published Business Plan and Risk Review, are an indication of its intent to move quickly. That many insurers feel that this is too much too soon, is an indication of the mismatch of expectations between the industry and the FCA.

Concerns include how the FCA should pursue its objectives about competition and value for money and worries that the FCA will become a price regulator. The FCA has argued against direct price regulation but the industry's concerns are being heightened by developments such as the promise of regulation of pay day lending charges, caps on pension charges, and fears of retrospective regulation of charges on legacy products. It is clear the FCA has concerns over the value for money achieved by some customers, mobile phone insurance, legal expenses and annuities have all come under the spotlight.

There are also divergent views on the extent of change needed. Many insurers believe relatively minor adjustments are required and that the FCA's "shoot first and ask questions later" approach is overly aggressive. But when the results of this insurance survey are compared to a similar survey Oliver Wyman conducted with retail banks, banks have embraced more wholesale change. Andsince many of the interviewees were able to point to existing insurance products and practices that do not perform well for customers, any belief that insurers will get off lightly is probably misplaced.

Insurers who believe that conduct risk can be addressed by enhanced processes and controls are missing the FCA's expectations. The regulator is less interested in the sophistication of risk appetites, risk tolerances and risk plans and much more interested in the simple issue of whether a firm's actions are ultimately detrimental to customer interests. Its agenda is focused on ensuring the strategy, leadership and culture of firms embrace good conduct.

The FCA articulates this by asking leaders to consider "should we?" rather than "could we?" before carrying out a certain activity.

This is a much bigger deal than having a single conduct risk policy. From the board right through to front line staff, firms' behaviour, attitudes and motivations must change to embrace good conduct and ensure that customer experiences and outcomes meet expectations. In many cases, quite significant changes to insurer business models and operating practices will be required.

Emerging issues

Differences have already emerged between the FCA's approach and that of the FSA's Treating Customers Fairly (TCF) regime. In part these reflect a shift in political and societal attitudes towards business, characterised in particular by demands for more openness, transparency and accountability.

Four emerging issues have the potential to become challenging for insurers.

Key Emerging Issues

1. A focus on customer outcomes: Following the rules is not enough. The focus is on whether customers are getting good outcomes.

2. Ultra-transparency and value for money: Products and services have to stand up to a much greater scrutiny to prove that they offer value for money.

3. Desire for equality: More pressure to satisfy demands for equality of access to insurance and for the removal of discrimination in pricing.

4. Data dilemmas: Understanding customers' boundaries to protect privacy and on the acceptable and unacceptable use of customer data.

A focus on customer outcomes

Following the rules is no longer enough. There will be a much greater focus on testing whether customers are getting good outcomes rather than on the processes followed by insurers.

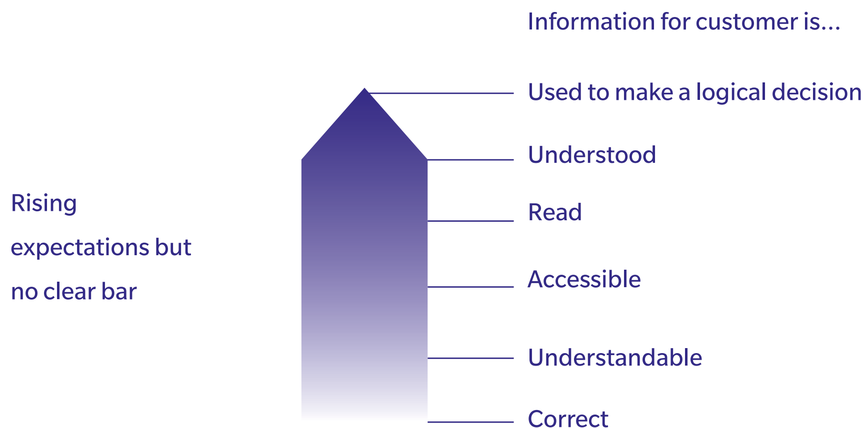
Unfortunately, questions remain unanswered over how far insurers should go to ensure the goal of a good customer outcomes is achieved:

- At what point does the customer have to take responsibility for ensuring that they understand the products and that the products are suitable? Even where all the right information is presented, how many customers can be observed making sub-optimal or poor decisions before an insurer should take action? And what should this action be?

- What are the insurer's responsibilities when the product is being sold by a third party distributor? If the insurer, as product provider, is aware that many customers are not receiving good outcomes, they will be expected to take action. If they are not aware of a widespread failing by a distributor, they will be asked why they did not do more to check that good customer outcomes were being achieved.

It will become unacceptable to observe poor customer outcomes and take no action, particularly when this occurs systematically. A defence that "we did nothing wrong because we followed the rules" will be of little consequence if the outcome for customers was palpably poor

Levels of responsibility for insurers to ensure customers get positive outcomes:



Value for money

Ultra- transparency means that all products and services will need to stand up to public and regulatory scrutiny and prove that they offer value for money. The FCA will intervene on behalf of consumers who it deems unable to determine if a policy represents a good deal.

Insurers need to assess much more critically how they determine the value their products offer. Relying on price disclosure will not be enough if there is insufficient benefit underpinning the value or usefulness of a product. This is more complex than just margin, or whether one company's price is better than another's. However, when the price is materially above competitors', the margin unusually high, or commissions account for a significant proportion of premium, this should be justified by additional value for customers.

The test for insurers may be to ask how the regulator, media and customers would react if all the details of a product were fully transparent and in the public domain. That is, charges, commissions, claims levels, margin etc. If the answer to this question feels uncomfortable for management, then action is probably required.

An outcome of the focus on value for money is likely to be the development of less complex and easier to understand (and explain) products.

Desire for Equality

More pressure can be expected to satisfy demands for equality of access to insurance and for the removal of discrimination in pricing.

While insurers can accept that some customer groups are priced out of the market or are otherwise disadvantaged due to their risk, this is unattractive from a public policy perspective where insurance is considered as a social good. Politicians will intervene under the guise of equality, as we have already seen in gender neutral pricing and explicit subsidies for flood insurance.

Regulators should not prohibit differential pricing, nor should all customers be offered an equal price; lower risk customers should expect to pay less. Likewise, it should be reasonable for insurers to use lower pricing as a means to grow market share or reward loyalty. However, in relation to new and existing customers, insurers might need to consider where their pricing sits between recovering initial investment in acquiring a customer and deliberately exploiting customer inertia over the longer term of a contract.

Each insurer will need to determine its own comfort level and ensure that an appropriate balance between individual underwriting, pooling of customers and the principle of access to insurance for all sections of society.

Data Dilemmas

Technology and Big Data create opportunities in product design, pricing, customer targeting, servicing and claims management. However, even while operating within the boundaries of the law, questions remain about the limits of what is acceptable use of customer data.

Insurers need to check that they are not exploiting technology and data opportunities faster than customers want. As well as being confident that they are operating within the letter and spirit of all relevant laws and regulations, leaders need to make sure that they can defend the sources and use of personal data. This will require the development of clear guidance on the use of customer information with reputational risk in mind.

Insurers should also look closely at how they store, manage and secure data. As the amount of personal data being captured and stored grows the challenge increases. We expect the regulator to become more vigilant and less tolerant about how insurers manage and control customer data.

Conclusion

There is concern that too much regulation could reduce competition and innovation to the detriment of consumers. But, whether or not they agree with the FCA's diagnosis of the market, it is important for insurers to identify the significant trends of openness, transparency and accountability that will shape the nature of conduct regulation.

Insurers who consider that conduct risk is simply an evolution of TCF are likely to find themselves on the wrong side of the FCA. They could also fall behind as other insurers develop business models, products and cultures more attuned to today's society. The FCA requires insurers to take a self-critical view to identify any business practices that need to change, supported by a rigorous focus on ensuring the firm's leaders and culture set the right tone for the business.

Conduct Risk for Insurers: Responding to a fundamental shift in regulatory expectations, published by Oliver Wyman and the CII, is available at www.oliverwyman.com

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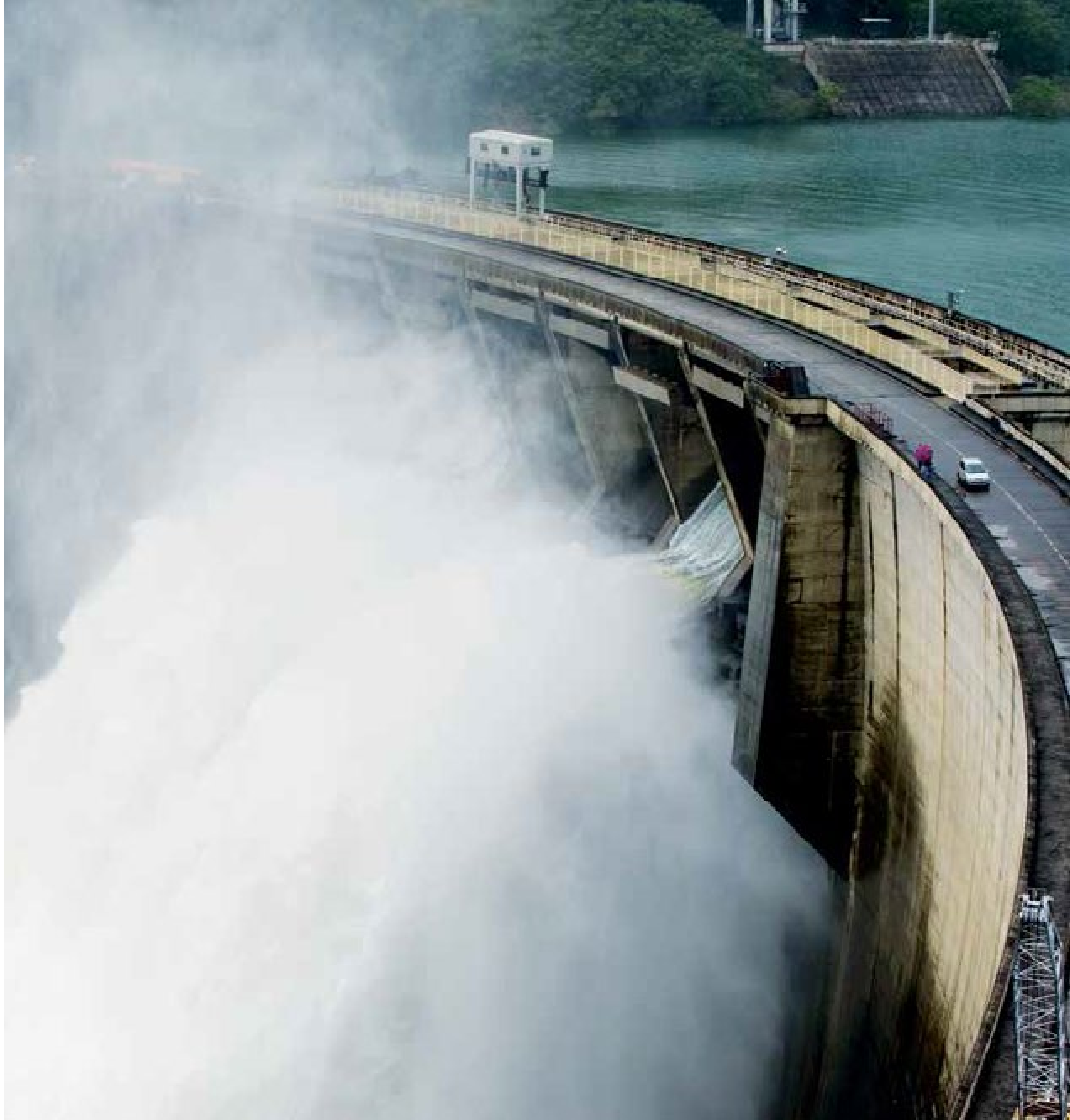


CONTROLLING VOLATILITY

WHY INSURERS EXIST AND WHAT THAT MEANS FOR THE FUTURE EVOLUTION OF THE INDUSTRY

JAN-HENDRIK ERASMUS

The first recorded instance of insurance took place in China in the third millennium B.C. Merchants traveling treacherous river rapids would redistribute their wares across many vessels to limit the loss should any of the vessels capsize.

This arrangement allowed the merchants to achieve widely expected outcomes, which were certainly more predictable than 100 percent of goods or zero percent of goods.

The earliest identifiable case of insurance conducted as a separate business was also marine insurance. By 1574, there were 30 sworn brokers in London who produced policies underwritten by London merchants. Although this developing insurance market in London was subject to competition in the 17th century from shipping centers such Amsterdam, Edward Lloyd's coffee house became recognized as the place for obtaining marine insurance, and this is where the Lloyd's of London that we know today began.

Marine was only the start. Fire insurance, life insurance, pensions and annuities, protection against hailstorms, livestock disease, plate glass window protection for shopkeepers, fidelity insurance (protecting businesses against fraud by staff), personal accident insurance, protection against burglary, and motor insurance: all were being offered by commercial businesses before the 20th century.

PROVIDING CERTAIN OUTCOMES

To manage their customers' uncertainty, insurers must be good at managing their own risks, and they have spent at least 300 or so years figuring out how to combine individual exposures into risk portfolios with predictable outcomes. They have developed many sophisticated practices, but the core value add remains taking a collection of uncertain outcomes resulting from events such as hurricanes and combining them in a way that provides certainty to clients and relative certainty to the insurer itself.

300

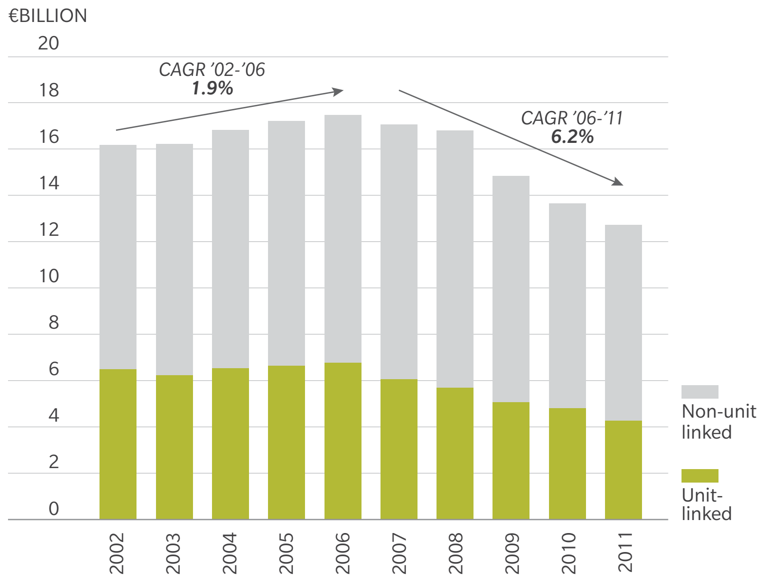
The number of years that insurers have been combining individual exposures into risk portfolios with predictable outcomes

As early examples illustrate, the primary role of insurers is to provide customers with certain outcomes in place of uncertain ones. How much will you lose from car theft tomorrow? Either nothing or the value of your car, depending on whether or not your car is stolen. With car insurance, you know that, either way, your loss will be the insurance premium. The same goes for your house burning down, your becoming ill, your retirement income collapsing because of low returns on investments, and for a host of other insurable events. With insurance, you know how much these unpredictable events are going to cost you: namely, the cost of the policy.

Five categories of insurance are sold in Europe today:

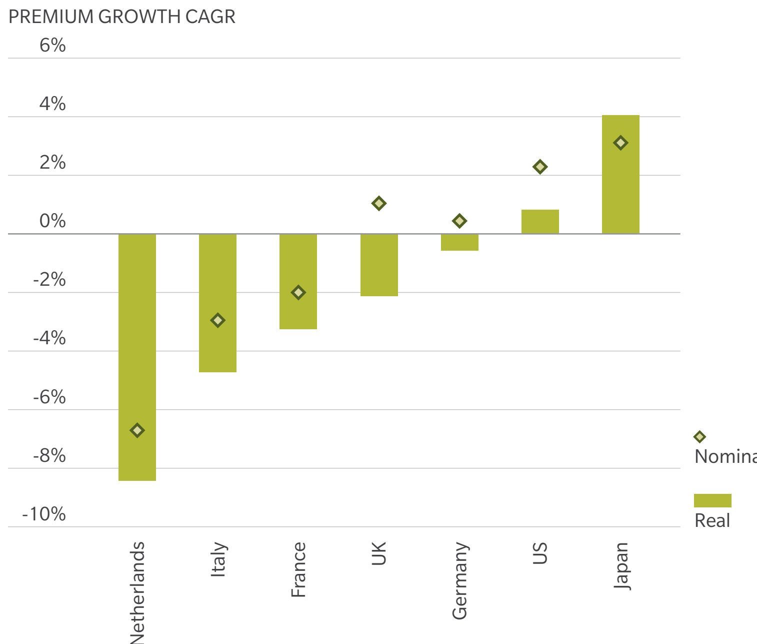
1. Non-life, where the insurer is protecting the customer against a loss of property
2. Life risk, where the insurer is protecting the customer against the financial consequences of unexpected death or related events such as critical illness

EXHIBIT 1: HISTORICAL GROSS PREMIUMS OF INDIVIDUAL LIFE IN THE NETHERLANDS



Source: DNB

EXHIBIT 2: LIFE PREMIUM GROWTH 2009-2011



Sources: Axco, Oliver Wyman analysis

3. Life savings with guarantees, where the insurer is allowing the customer to either save for retirement or draw down an income during retirement on guaranteed terms. The guarantee is crucial as it reduces the volatility of potential customer outcomes.
4. Life savings without guarantees, also called "pure" unit-linked or "defined contribution." Although popular as a savings vehicle, this class of product does not reduce the volatility of customer outcomes.
5. Health insurance, where the insurer is protecting the customer against the costs associated with unexpected healthcare requirements

Insurers have no structural competitive advantage in providing life savings without guarantees, and we believe that volumes will quickly be eroded as alternative providers innovate and become more cost efficient. This trend is already visible in the Netherlands, where individual life savings product volumes have fallen each year since 2006.

However, products that do not help customers manage risk explicitly remain a substantial part of new insurance business. In 2011 in the UK, for example, such products accounted for over 60 percent of the total premium income of $428 billion.

It follows that less than 40 percent of the written premiums in 2011 were in relation to products with volatility management for customers at the heart of their design.

In the 60 percent of insurers' business that requires little to no specialist insurance risk, they face fierce competition from noninsurers such as asset managers and

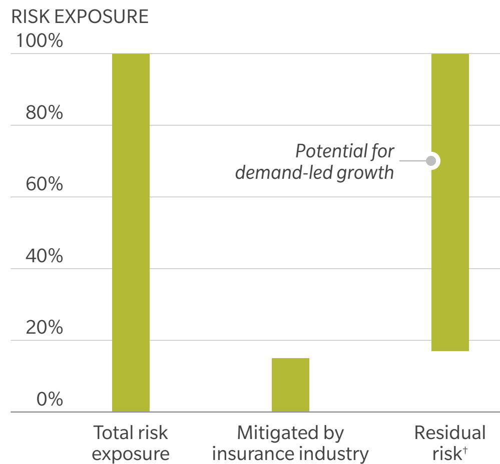
banks. The regulations and tax advantages that once protected life insurers in many European markets have been eliminated. Platform providers, asset managers, and banks are capturing new business flow from insurers and putting pressure on margins.

With real premium growth in most European markets negative in recent years, as shown in Exhibit 2, and more efficient non-insurance competitors, victory in this battle should not be a strategic priority for the majority of insurers.

But there is good news, too. Our analysis indicates that fewer than 20 percent of the risks that customers are exposed to today are currently insured. (See Exhibit 3.)

This means there is potential for demand-led growth. Insurers that focus all their efforts on retaining their pure savings business, probably via a combination of cost reduction and technology-led process improvements, may miss the big opportunity to increase the amount of risk protection they provide.

EXHIBIT 3: GLOBAL BREAKDOWN OF MITIGATED AND UNMITIGATED RISKS*



Source: Oliver Wyman estimate

* Including all enterprises and private households

† Retained or partially mitigated via capital markets or state provision

CONCLUSION

We expect that over the next 10 years, insurers will be able to grow their core risk-related business in the following areas:

- Health insurance: for example, covering new diseases, epidemics, secondary risks of treatment, and biometric coverage
- Protection against death: for example, increasing access to life coverage and its flexibility
- Protection against living longer than expected: for example, providing access to longevity coverage without a bundled savings component
- Property: for example, responding to new patterns in vehicle ownership and linking property protection to property management

Capturing such opportunities will require insurers to be innovative both in their product development and their marketing. If they instead devote themselves exclusively to defending current positions, not only will many fail to win that battle, they will miss the growth opportunities that play to their strengths.

Jan-Hendrik Erasmus is a London-based partner in Oliver Wyman's Insurance practice.

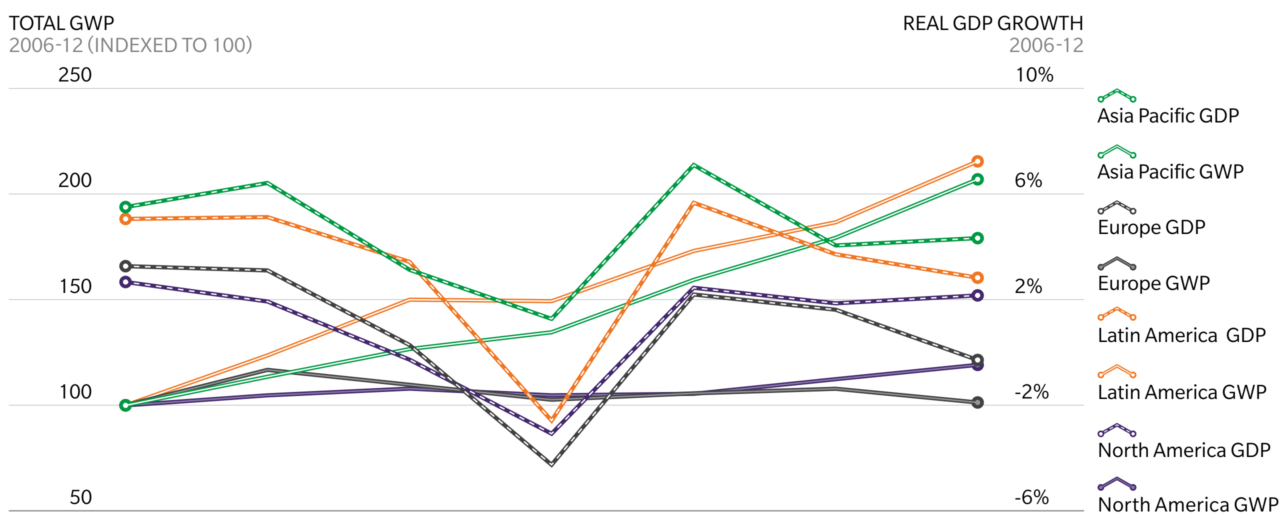
RETURNING INSURANCE TO GROWTH

BERNHARD KOTANKO
JOHN WHITWORTH

Insurance in mature markets has apparently reached a saturation point, unable to grow faster than GDP. While growth in life and pensions premiums varies with regulatory and tax regimes, property and casualty (P&C) insurance premiums are actually contracting. Overall, real premium growth has been close to zero over the last ten years.

Unsurprisingly, the same is true of insurers' earnings-per-share and market values. Since 2002, Stoxx Europe Insurance has grown by barely 3% and Stoxx North America Insurance is still 2% down. Over the same period, the Stoxx Global 1800 grew by almost 70%. It is only in the last two years that insurance has staged a small recovery to its historic lows.

EXHIBIT 1: INSURANCE IN MATURE MARKETS HAS LOST ITS ABILITY TO GROW AT THE LEVEL OF REAL GDP AND BEYOND



Source: AXCO, World Bank. Included countries North America: US & Canada; Latin America: Argentina, Chile, Colombia, Mexico, Peru, Venezuela; Europe: Austria, Belgium, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Lithuania, Luxembourg, Netherlands, Norway, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, Spain, Sweden, Turkey, UK; Asia Pacific: Australia, China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, Vietnam.

Conventional wisdom accepts this low growth as an unavoidable consequence of market maturity, and senior managers try to maintain profitability by increasing efficiency and cutting costs.

We think this conventional view is too pessimistic. Six big developments present insurers with opportunities to accelerate premium growth in mature markets.

1. NEW RISKS

The way people live and conduct business is changing. And so, therefore, are the risks they face and the way these risks are connected. This creates opportunities for insurers to provide new products and services. For example, identity theft was almost unheard of 20 years ago. Now it is a risk worth insuring. Or, for another example, supply chains and their associated risks have changed dramatically, involving technology that either was not used or did not exist 20 years ago. Where simply insuring a vehicle or specific "business interruption" may have once sufficed, businesses are now more likely to require a comprehensive supply chain policy. Even the dramatic increase in divorce and second families creates potential demand for new insurance products.

2. UNITARY POLICIES

Insurance policies have traditionally been designed and priced for large groups of only roughly similar people. Variation within these groups means that most customers are either under-priced or over-priced, and few get the precise cover that suits them. The massively increased quantity of information now available to insurers, from the internet and technology such as telematics, means that policies can be tailored to the particular characteristics and behavior or policy holders. This means insurers can now create "segments of one".

Just as a shoe shop that could always produce a pair that fits would increase sales, so should insurers who can create segments of one. Such precise targeting of policies can also be aimed at individual occasions or assets as well as individuals. For example, personal injury insurance can be sold just before the ski trip and last only as long. Similarly, new "annex" insurance policies are achieving impressive growth at high margins for small assets such as glasses, mobile phones, or online transactions.

3. PUBLIC TO PRIVATE

Governments tax citizens and then provide them with "free" pensions, health insurance, old-age care and unemployment insurance, among other things. Commercial insurers have thus been largely crowded out of these markets. However, the level of cover provided by such "social insurance" will need to fall in many western countries. Populations are aging and governments are already near their fiscal limits. This will create opportunities for insurers to fill the gaps left by retreating governments. Even moderately affluent people are likely to be dissatisfied by the level of social insurance or even excluded from it.

4. LONG-TERM SAVINGS

The global asset pool grows at a stable rate of 4-6% and the need for long-term savings is increasing at an even faster pace with the aging of the population. Insurers are a major collector of these savings and thus one of the largest institutional investors. Maintaining and expanding this role as a premier collector and manager of long-term retirement savings could be a critical source for further growth. This may include the full step into asset management, which some global insurers have already made.

5. PROFITING FROM ILLIQUIDITY

Unlike banks, insurers have very stable, illiquid liabilities. Pension and P&C claims cannot be "called" by the policy holders. Rather, they pay out in a predictable fashion, uncorrelated with the economic cycle. This makes insurers natural investors in illiquid assets, such as commercial loans or infrastructure, which pay illiquidity premia that insurers are now failing to capture. Regulation is partly to blame, with solvency requirements driving up the cost of holding such assets. But, as we have argued elsewhere, even with these regulations, insurers could increase their market value by up to 50% by exploiting the stability of their liabilities for investment in illiquid assets. This however will require an entirely new set of capabilities and capital markets access for insurers.

6. BEYOND INSURANCE

Insurers have unique information about the risks facing individuals and businesses. This can be used to provide more than just insurance policies. Insurers should be able to offer services at many points on the "risk value chain". Examples include the use of actuarial insight in accident prevention, telematics in cars and supply chain management for businesses.

Each of these opportunities involves uncertainty. Will there be sufficient demand? Will regulators intentionally or inadvertently shut down the opportunity? Will the new ventures and products be well designed and profitable? To pursue them, insurers must take steps into the unknown.

Many will be reluctant. Insurance firms have notoriously conservative institutional cultures. This has usually served them well. But in the current situation, caution will be costly. It will lead to another decade of stagnation. Insurers must become more entrepreneurial and innovative. That will require them to develop not only their capabilities in product development but their willingness to live with uncertainty. With a little strategic courage they should be able to return to real growth.

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OLIVER WYMAN

EXANE BNP PARIBAS

FRENCH LIFE INSURANCE

One life ends; another begins

8 JULY 2013

François Boissin

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WHY YOU SHOULD READ THIS REPORT

With around EUR1.5 trillion in funds under management, French life insurance is a large and mature market. However structural issues including poor profitability, risk of lapses, and market conditions suggest the potential demise of the traditional life product in its current form.

All is not lost, though. In the short term, insurance companies should consider pulling a number of levers to enhance the value of their business. Longer term, the inevitable cut in pay-as-you-go pensions could lead to the emergence of a proper private pension market in France.

This report discusses actions that insurers could take now to improve current profitability and to seize future growth opportunities.

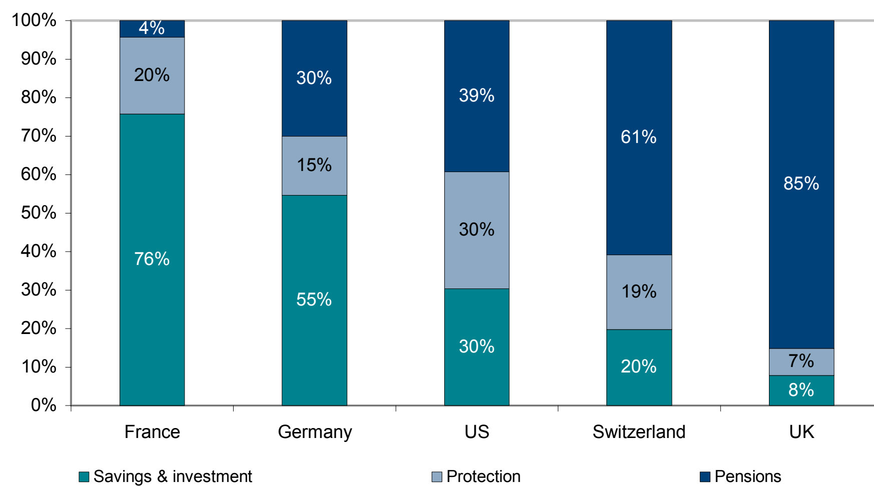
Executive summary

French Life: What is wrong?

After 30 years of impressive growth, French life insurance has become a large market with c.EUR1.5 trillion in funds under management. The bulk of this growth has been fuelled by the savings business. France has opted for a pay-as-you-go pension system and as a result, contrary to some other OECD countries, a proper private pensions market has not emerged.

Figure 1: French life insurance sales are heavily geared towards savings

Breakdown of annual life insurance premiums (2011)



Source: Swiss Re Sigma, FFSA, Exane BNP Paribas, Oliver Wyman

As it stands, the French life insurance business is unappealing to investors. The main product "*fonds en euros*" offers generous guarantees to policyholders and is therefore capital intensive. We estimate that this product generates a poor c.4% return on capital for insurers. Unit-linked products are much more profitable but much less popular with consumers because typically they offer no guarantees.

In addition, lapse risk should not be under-estimated: the only penalty that policyholders face in case of early withdrawal is a loss of tax benefit. And even these penalties apply only when the product has been held for less than 8 years. Today, more than 65% of contracts are more than 8 years old, meaning that French insurers face significant withdrawal risk, especially in case of sharply rising interest rates, or renewed sovereign stress. Life insurers in most other countries are much more protected against this risk, thanks to more stringent product features.

What's more, with low interest rates and on-going de-leveraging, net new lending is declining and with it, the creation of bank deposits. This should slow demand for life insurance products and weigh on future growth prospects.

How to protect the back book of business?

Despite poor returns on capital, we believe there is value in the large back books of French life insurers. In our view, insurers could selectively cut credited rates on *fonds en euros* products with minimal loss of volumes and significant uplift in investment spread margin. Products should be re-designed: *Euro-croissance* with at-maturity guarantees or unit-linked products with guarantees look promising. However these products would not be liquid for private investors and are therefore unlikely to replace fully the current *fonds de euros*. We also see scope to re-risk investment portfolios namely by capturing long term illiquid premiums. Lastly, we believe that operating costs can be managed down further.

We believe that these recommended actions are worthwhile. Insurers who take them should get an edge over those that do not. Yet they will not transform the generally forlorn position of the French life insurance industry. For that, we see only one serious possibility: the emergence of a large private pensions market in France

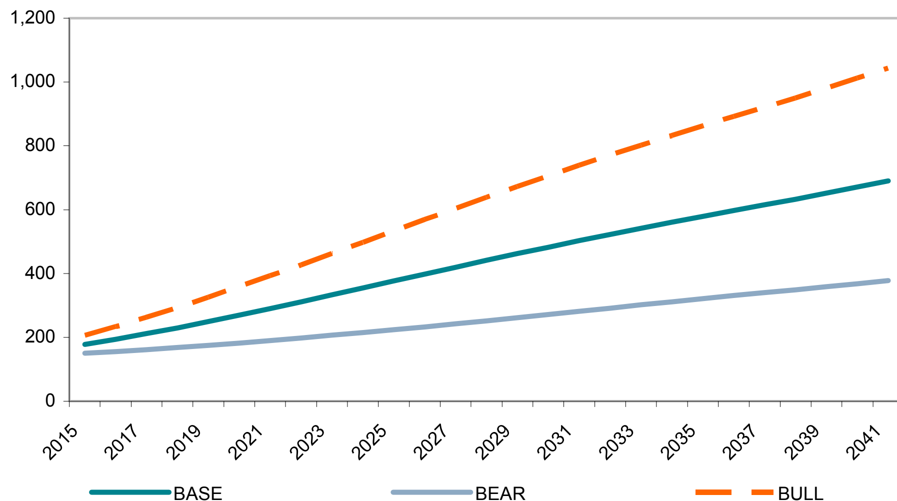
The private pension opportunity

The greater hope for a significant turnaround in the fortunes of French life insurers arises from the problems facing the French compulsory pay-as-you-go pension system. The viability of such schemes depends on the ratio of contributors to retirees. This ratio has declined sharply over recent years as life expectancy has increased, baby-boomers have retired, and unemployment in people of working age has risen. The system now has an annual deficit of EUR14bn, which is expected to rise to EUR63bn by 2060 according to public sources but which, using more realistic economic forecasts, we expect to rise to EUR135bn.

The French government will eventually be forced to reduce the value of retirement incomes provided by its pay-as-you-go scheme. This will result in a dramatic increase in the number of French households that make private provisions for their retirement. By 2040, we estimate that pension funds under management could range from EUR400bn to EUR1.0 trillion vs. c.EUR140bn currently.

Figure 2: The private pension potential, total AuM forecasts

2015E-2040E (Base, Bull, Bear case scenarios) in EURbn



Source: Oliver Wyman, Exane BNP Paribas

We believe that – depending on policy developments – insurers are likely to provide the mix of risk, return and liquidity features most attractive to people saving for retirement. To take advantage of this opportunity, French life insurers must make sure that they are ready with the right pension products and that they have suitable distribution capacity, both in Group and Individual Life. They must also continue to engage actively with the government as it develops policies in response to the growing crisis in the pay-as-you-go system.

The full report 'French Life Insurance: One life ends, another begins' is available at www.oliverwyman.com

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