OLIVER WYMAN

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IN THIS ISSUE

MARSH & McLENNAN COMPANIES

INTRODUCTION

Few companies have impacted the global insurance landscape like AXA. Oliver Wyman had the opportunity to speak to Henri de Castries, Chairman and Chief Executive Officer of AXA about the key to the insurer's recent success, the trends shaping the business and his optimism for the future. He openly discussed the role of insurers in stabilising the economy and the opportunity for the life and pensions industry to provide a new source of long-term funding to the economy.

Solvency II continues to follow an elongated path to implementation. Many insurers are now assessing whether to and how to prepare for this new regulatory world. Old Mutual has been one of the leaders in transforming its business ahead of Solvency II with its iCRaFT programme. Old Mutual formally closed down the programme and transferred responsibility to the business ahead of schedule and below budget; exceptional situations where Solvency II activities are concerned.

Both articles have one overarching theme which we strongly advocate with our clients: to move onto the offensive and to be proactive in these challenging times. Whether it is the continuous innovation in a Group like AXA, or the willingness to make your Solvency II program a success at Old Mutual, or not being affected by regulatory uncertainty or market volatility. Insurance is an important source of stability in our society and economy. We should not accept low growth, little trust from customers and limited innovation. Identifying new sources of growth, driving change and innovation, and optimising risk and return are the levers for a successful insurance sector.

With this in mind, I hope you find this edition of the newsletter an interesting read and would welcome your comments.

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A CONVERSATION WITH HENRI DE CASTRIES

Chairman & Chief Executive Officer, AXA

Interview conducted by **Fady Khayatt** and **Jan-Hendrik Erasmus**, Partners in the Financial Services Practice of Oliver Wyman

OLIVER WYMAN: *Unlike some of your competitors, AXA reported solid half-year earnings in 2012. What do you think has been the key to this success?*

HENRI DE CASTRIES: I attribute our success to a fairly simple strategy, with a focus on execution. The efforts we have made as part of our middle-term plan, called "Ambition AXA", are starting to bear fruit. We are making good progress on the efficiency front, making sizeable savings, but we are also repositioning the group towards further developing our Property & Casualty as well as Protection & Health segments, and being more selective on the savings and asset management side.

We are also repositioning ourselves geographically to try and accelerate in high-growth markets, and to be more selective in mature markets. These changes are proving successful, even though the macro-environment and some areas of the business remain challenging.

AXA famously built itself on bold strategy moves - most notably large acquisitions across the globe. How does this fit with your plan Ambition AXA? Are you happy with the geographic presence of the Group?

Taking a step back, it is important to note that globally speaking, we no longer have any issues in terms of scale. That was not the case at the end of the last century when there remained areas where we needed to significantly increase our scale to survive in the long run. The question now is whether we are well positioned, and what we can extract from our existing businesses. It is a combination of building on what we already have in some markets in order to gain market share organically and, in some cases, doing add-ons. We do not need any big transformational deals; it would be pointless, particularly in this environment where regulators no longer like big institutions.

> *You should not neglect what you can extract from mature markets as they too have distribution systems and business segments with double digit growth potential*

Yes, it is indeed about being more selective, reinforcing strengths and removing operations with limited prospects, whilst organically developing the rest of the business. For example, last year we sold our Canadian Property & Casualty business which was a well-performing business with very nice returns but limited growth prospects. We sold it at high multiples to a local player which could value and pay for synergies. It has proved to be a win-win deal. Intact Insurance is now the largest P&C player in the Canadian market, with a market share which is going to be very difficult to match by any other competitor, and we are happy because we have extracted a significant amount of value from the business. We have redeployed the money to the development of our business in Asia and other emerging countries.

With regards to acceleration, the framework that you use to understand growth shouldn't just be geographic. There is a significant amount of growth available, even in mature countries. Asia is a probable area of significant growth, but it is not the only one. South America, the Gulf and Turkey are also places where interesting things can be done. So we have been positioning ourselves in the core markets of these regions.

But you should not neglect what you can do in mature markets as they too have distribution systems and business segments with double digit growth potential. To give you a couple of examples, the direct business is showing double digit growth, and not only in emerging markets. Also, the long-term care business in France this year is probably our strongest growth story: we have seen an increase of around 60-70%. This is in part due to the fact that the population has become increasingly aware of the need to find solutions in this area, and that we are bringing well-designed products to market. This is a great business for AXA because it provides regular premiums with a good business value, and it truly addresses fundamental needs of our clients..

You have been quite vocal with regards to the importance of optimising and having an active approach to capital allocation. Is this something you feel you can take much further?

The question in today's environment is quite straightforward because equity is expensive. Most of the players are trading at very low multiples, so they don't want to raise equity to develop their business if they feel that increasing the leverage is unreasonable. In which case the only way to develop your business is to improve your cash flows and reposition your equity. And that's what we've tried to do over the last three years. I think we are the ones that have been the most active in divesting some businesses which we thought were mature or not very rewarding in the long-term, and reinvesting the money in more promising segments or geographies.

What are the three long-term trends that are leading you to change the way you see your business?

This is a fundamental question, and one that shouldn't be limited to the short-term. If I look at the challenges we have in the long term, the macro-environment is not the biggest. It is likely to remain tough in parts of Europe in the coming years, but there are a number of very attractive markets across the world from a macro perspective.

As insurers, there are three real challenges we must address. The first is climate change and natural disasters because of their effect on the P&C business. The second is longevity and ageing and how are we positioned to deal with this challenge. The third is digitalisation. The internet is having the same impact that printing had in the renaissance, and it is dramatically changing the running of the economy and the

> *"The internet is having the same impact that printing had in the renaissance, and it is dramatically changing the running of the economy and the behaviour of customers"*

behaviour of customers. It has transformed the way we design products and organise our distribution and after-sales support. It is not just a case of building an additional distribution channel – this is a very small part of the answer – it is how you use it to make the company more effective in all its dimensions. It will lead to better customer service and a significant decrease in costs, including acquisition costs. The key obstacle to change for us is not the technical understanding of the advantages it can bring; instead, it is the human resistance to dealing with it.

Could you tell us a little about your objectives in setting up partnerships with Société Générale and Crédit Agricole in order to provide financing to businesses?

The objectives of the partnership are quite simple. Basel III has forced the banks to shrink their balance sheets. AXA has positive cashflows. In fact we have more than €450 billion invested assets on our balance sheet, and including third parties we manage over €1 trillion – which we need to invest. We no longer consider sovereign risks to be truly risk-free and so need to find alternatives to sovereign bonds. We also need alternatives to classic corporate bonds because all large investors have done the same thing, capping their exposure to sovereigns, despite growing cash flows, and moving to A and A+ corporate bonds. What is more, corporate spreads have significantly shrunk. So to capture margins you need to find new ways to invest, and partnering with banks – who need to continue to do some corporate lending – I believe is a good way for us to capture a portion of the spread and the illiquidity premium, in order to better serve our policyholders. It is an approach that is at the heart of our expertise in terms of Asset Liability Management, and one which opens the door to

"Traditionally insurers were long-term players, but the combination of Solvency II and the mark-to-market approach has largely destroyed that"

a wide spectrum of opportunities for us to contribute to the long-term financing of the real economy.

We have agreements in place with two French banks, Société Générale and Crédit Agricole, but this is only the beginning. We are looking at other structures as well as infrastructure projects as another way to put our money to work differently and efficiently.

Back to your point about long-term lending to the real economy, how significant a role do you think the life and pensions industry could have in this trend and who will be the winners in this space?

Traditionally insurers were long-term players, but the combination of Solvency II and the mark-to-market approach has largely destroyed that. I think we will have to return to that because the paradox in Europe is that you have high savings rates but that these savings are very poorly invested. They are poorly invested for several reasons, firstly because of poor financial education of the savers and secondly because tax incentives point savers in the wrong direction. In France, savers are directed to very short-term deposits such as the Livret A or to real estate, and are penalised for choosing long-term investments by high levels of taxation. The exception is life insurance contracts, where we as an industry have largely managed to maintain positive tax incentives, geared towards long-term investments.

The third element is regulations, which have evolved negatively over the past 10 years. I believe regulators and politicians don't have it right. I'm not saying that we didn't need to review the regulatory framework of the banking sector, but Basel III has gone too far in some of its components and what they have really done is thrown the baby out with the bathwater. In insurance, they run the risk of distorting Solvency II to the point where it would become total economic nonsense.

There has been much discussion within the industry about the role of insurance in stabilising the economy. What are your views on this?

We are natural stabilisers for two reasons: first, because of the long duration of our liabilities and second, because when we pay out on claims the money we give to clients is used to rebuild things that have been destroyed or damaged.

We are natural contributors to GDP growth. The paradox with the current regulation is it ignores the duration of the liabilities because it is artificially forcing investment with a one-year horizon. If you want to put the system on its feet again, you need to change that. Insurers will adjust; the losers are going to be the customers and society at large because it will lead to lower

"We want to be a school of fish, not a whale. Moving together with the same DNA but with flexibility"

growth. It is already obvious in Europe. European insurers over the last seven or eight years have sold €400 billion of European equities! At the turn of the century, we had approximately 20% of equities on our balance sheet, today we have 2.9%. The balance sheet has not shrunk, it has expanded. The model is creating a situation where either equity is more expensive for European insurers than for others, or it is owned by someone else, or companies are over leveraged and therefore more vulnerable to economic shocks.

What do you see as the biggest challenges for the industry in the long term and how do you intend to navigate AXA through these uncertain and challenging times?

Our business model is based on diversification as a way to mitigate the risks. We have three businesses, P&C, health and protection, and savings and asset management, and having these three businesses is the first element of diversification. The second diversification is the geographic one. The combination of these two elements has made the group much more resilient. That being said, on a daily basis risk management has to be efficient. Not that we haven't made any mistakes, but risk management is an area where we have been very cautious and so far it has worked very well.

If I look at the world in general, my concern is not the breakup of the Euro. In fact I think the probability of the Euro persisting is high. My concern is the lack of structural reforms in some European countries leading to periodic crises before we go to a real adjustment.

Our recent work with AXA at both Group and local entity levels has demonstrated to us the challenges and strengths of operating within a large Group with strong local teams. What are your views on this?

Every day there is more convergence across the Group for obvious reasons. First, it is a way to reduce the risk. Second, it is a way to reduce costs. And, lastly, it is a way to improve the quality of what we do. The Group was built through acquisitions in different countries. The companies we bought had their own cultures and personalities. But the people that have been joining AXA since we acquired these companies don't have this luggage, so over time things are changing.

The creation of the global business lines which we put in place a little over two years ago is an element of forced convergence, which I believe is working very well. I don't want us to be centralised nor fully integrated because this does not work. The image I use internally is that we want to be a school of fish, not a whale. Moving together with the same DNA, but with flexibility.

You attended both the HEC, the leading business school, and the Ecole Nationale d'Administration (ENA), one of the country's grandes écoles, with new Socialist President François Holland. If he were to ask what you consider to be the most urgent reforms required to accelerate the French and European recovery, what would your response be?

Our new government will be assessed over the next five years on its ability to conduct the structural reforms the country needs to relaunch its economic competitivity and therefore its growth: promote long-term investments to support productivity and kick-start supply, lighten the fiscal weight that is becoming a huge drag on corporate profitability and growth, reduce public spending etc. If these reforms are not implemented, we run the risk of significantly subduing growth, increasing unemployment and making it all the harder as time goes by to reduce the country's deficit. And this picture as I have just

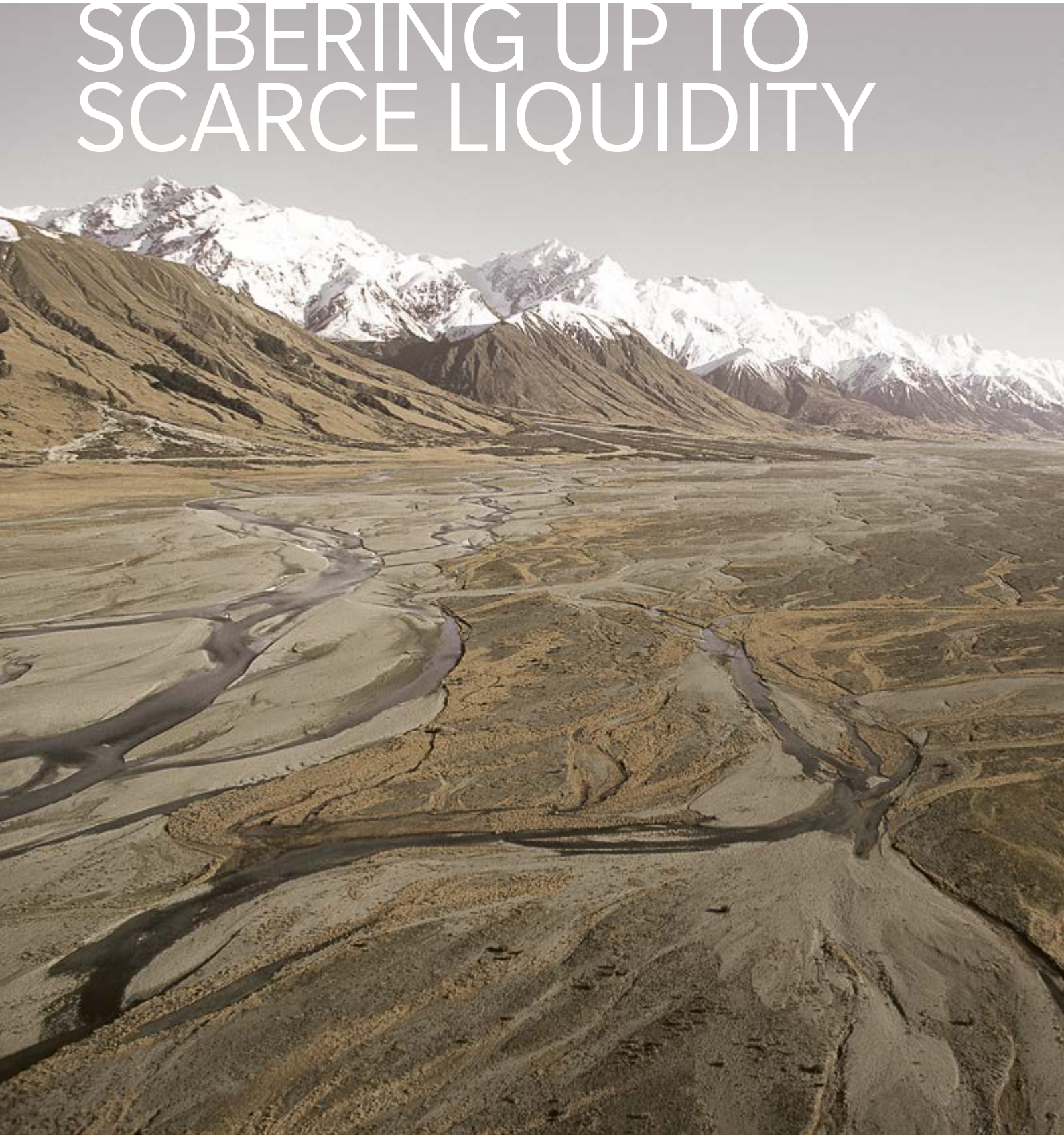
painted it is not sustainable, something will have to give. This being said, resiliency is also one of the nation's key characteristics – the easiest way to explain what I mean is by using the rugby match metaphor: France has an unmatched ability to spoil its successes, but it also has an unmatched ability to rebound from its disasters.

And finally, what makes you optimistic about the future?

With regards to the insurance industry, when I observe the evolving needs of our customers, everywhere in the world, it comforts me in my conviction that this is a growth business, and that we're in it for the long term. More generally I am also optimistic because I believe the world is changing for the better. Look at the rate of technological development, at the ability of some countries to manage a better future for their citizens even if the political systems are never perfect: overall, there are more people living well today than yesterday or ten years ago. Even if European societies are challenged (and we've seen the same story throughout history), it is up to them to drive their own future.

> *"France has an unmatched ability to spoil its successes, but it also has an unmatched ability to rebound from its disasters"*

SOBERING UP TO SCARCE LIQUIDITY



FINANCIAL RESOURCE MANAGEMENT FOR BANKS AND INSURERS

SIMON COOPER
JOHN WHITWORTH

The populations of most western countries had negative savings rates before 2007, spending more than they earned, and borrowing to cover the difference. Most western banks had loan-to-deposit ratios in excess of two to one.

But this did not increase their funding costs because wholesale funds were extraordinarily abundant. Banks could be leveraged 35 to one and still pay almost no "risk premium" in the wholesale markets thanks, in part, to the massive growth of savings in emerging markets and to the perception (accurate, as it turned out) that even wholesale bank debt enjoyed government guarantees.

This almost free leverage allowed many banks to deliver returns on equity above 20 percent. So, equity capital was also in easy supply. In short, when it came to the principal resource of banks—namely, debt and equity capital—the basic economic problem of scarcity seemed to have been abolished.

Of course, this was an illusion. And, like most illusions, it was dangerous. It removed banks' incentive to be astute managers of their financial resources. A business gains no advantage over its competitors by being better at managing a resource that is free, such as the air we breathe. While debt and equity capital flowed cheaply to all banks equally, regardless of the risks they were taking, they became careless managers of it.

We all know what happened next.

Now banks find themselves with exceptionally scarce and expensive financial resources. Indeed, private investors are so reluctant to provide European banks with funding that most depend on the European Central Bank. Managing scarce financial resources—a skill that had little relevance to banks only five years ago—is now a matter of existential importance.

COMPLIANCE IS NOT A STRATEGY

At the same time that equity capital and long-term credit, such as illiquid bank liabilities, are becoming painfully scarce and expensive, regulators are demanding banks to hold more of both of them. This effectively forces banks to increase lending margins to raise capital from retained earnings and to deleverage, often by reducing lending, which Basel 3 demands be funded by illiquid liabilities. Under these conditions, bank managers may well feel that when it comes to managing financial resources, simply complying with the new regulations is ambitious enough.

Managing scarce financial resources – a skill that had little relevance to banks only five years ago – is now a matter of existential importance

That would be a mistake. New capital and liquidity rules force banks to move down the risk-return spectrum. For some lines of business—such as over-the-counter derivatives trading—the increased capital and liquidity requirements are so great that many banks shouldn't comply, but should exit. Banks have displayed lamentable inertia about strategy since 2008, continuing with lines of business that have no future even today.

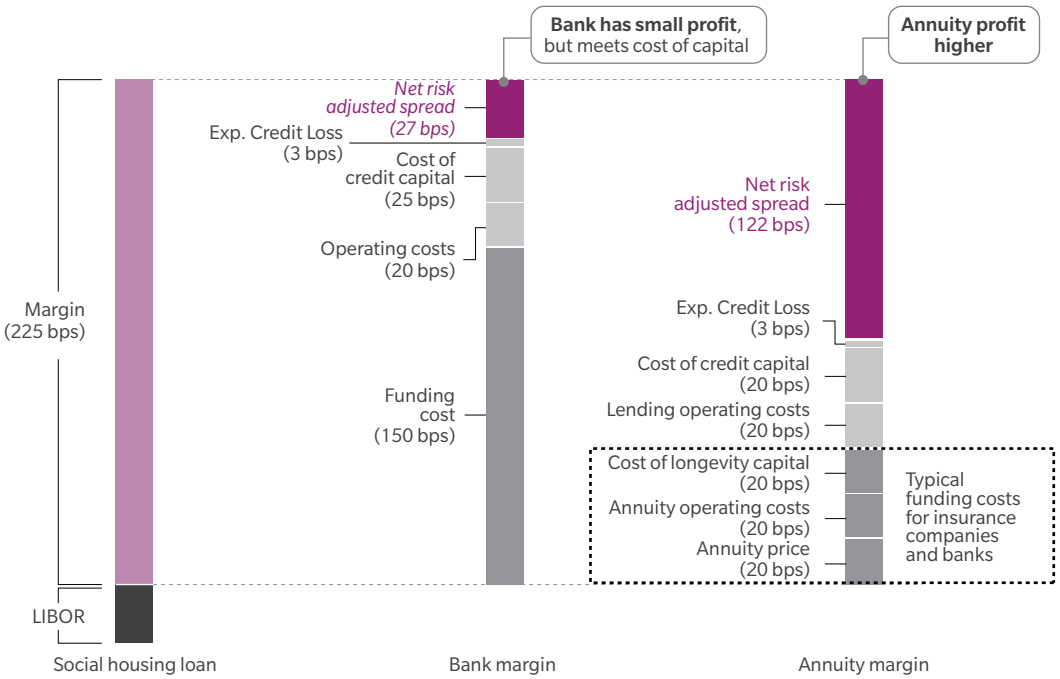
Moreover, for the lines of business that remain viable, strategic decisions need to be far more influenced by financial resource considerations than they were in the pre-2007 era of abundance. A bank's capital and funding requirements can no longer be something it discovers after deciding on its strategy. They must be the first considerations in setting strategy. For example, businesses that naturally generate illiquid liabilities, such as retail branch banking, have become much more valuable since 2007.

Financial resources are allocated not only by the strategy and planning process. Most decisions made by customer-facing staff and their managers have implications for capital and liquidity. Alas, these decisions are often evaluated and rewarded in ways that take, at best, only partial account of their financial resource implications. The demands that business decisions place on the banks' liquidity are commonly poorly reflected.

Banks must remedy this failing in their performance management and incentive schemes. Only rarely is there a measurement problem. The pre-2007 efforts to comply with Basel 2 provided most western banks with improved risk measurement capabilities.

While these should certainly be improved, the real trick is to use them not just for reporting and regulatory compliance but for informing business decisions. When financial resources were abundant and cheap, it did not matter much. Now it does.

EXHIBIT 1: ANNUITIES NOW PROVIDE A MUCH MORE EFFICIENT SOURCE OF DEBT RELATIVE TO BANK FUNDING*



Source: Oliver Wyman analysis

* Based on a representative 15 year secured social housing loan

RISK MEASUREMENT IS NOT RISK MANAGEMENT

As noted, the new liquidity rules of Basel 3 increase the value of businesses that naturally generate stable liabilities. There is no evidence that insurers lobbied for these rules, but they should have.

Life insurers especially have remarkably stable liabilities. For example, annuities are for life. Once a customer buys an annuity, it's difficult to reverse course, forgo the promised income, and have what is left of the capital returned. The customer is locked in. This means that insurers are perfectly placed to take advantage of the problems banks are facing. Insurers can supply the long-term credit that banks no longer can. They have a historic opportunity to expand their role on the provision of credit.

This may sound odd to those who are familiar with the provisions of Solvency II, the new regulatory framework to be applied to European insurers from 2013. Solvency II sets capital requirements for insurers and, among other provisions, it makes insurers capitalize the debt instruments they invest in on a mark-to-market basis.

Without a volatility damper such as the Solvency II matching premium, this makes the value of long-term debt instruments volatile and significantly increases the amount of capital that insurers must hold against them. The exact outcome of Solvency 2 is still to be finalized. If a matching premium is not permitted, the standard view is that it will lead insurers to reduce their holdings of long-term debt.

Insurers can supply the long-term credit that banks no longer can, giving them a historic opportunity to expand their role within the financial industry

But this ignores the fact that banks are facing new, and heavier, burdens. Even allowing for the effects of Solvency II, the illiquid liabilities of insurers mean that they still enjoy a structural advantage over banks. A typical return from making a corporate loan should be around 65 basis points higher for an insurer than for a bank assuming an unfavorable Solvency II outcome, or 90 basis points higher assuming a positive Solvency 2 outcome. (See Exhibit 1.)

Alas, insurers are displaying the same strategic inertia as banks. With a few small exceptions—such as Aviva's commercial mortgage lending in the United Kingdom—insurers continue to limit their credit business to buying liquid debt instruments, such as government bonds and high-grade tradable corporate debt.

Making long-term loans or investing in illiquid debt instruments would require insurers to extend their sales and risk-assessment skills. But this is not an insuperable challenge, especially given the number of bankers who have recently been made redundant. Given the lackluster shareholder returns of most insurers over recent years, they ought to pounce on this opportunity for profitable growth.

Everything has changed since 2007. Financial firms became blind-drunk, passed out in an oasis of capital and liquidity, and awoke in a desert. Yet, if you look at their 2012 business models, you might think that little has changed. They still do many of the same things, and their decisions still pay scant attention to the financial resources that are available to them.

Regulatory uncertainty and ongoing support from central banks may explain this. But they do not justify it. Managers of financial firms must clear their heads and adapt to the new world of financial scarcity. They must become expert financial resource managers.

Simon Cooper is a partner in the Finance & Risk Practice. **John Whitworth** is a Partner in the Insurance Practice

TIPS FOR A SUCCESSFUL SOLVENCY II PROGRAMME:

INTERVIEW WITH ADRIAN THORNYCROFT

Old Mutual Change Director, Old Mutual Wealth (Skandia)

Former Programme Director, iCRaFT

INTERVIEW CONDUCTED BY **DAVID DULLAWAY**, PARTNER, OLIVER WYMAN

The Old Mutual Group's Solvency II programme, iCRaFT, formally closed down and transferred responsibility to the business early in 2012, ahead of schedule and below budget. This is at odds with typical Solvency II programmes, where overruns are common. We talk to Adrian Thornycroft, Old Mutual's Solvency II programme director, about the reason for their success. Oliver Wyman assisted Old Mutual in planning and delivering their programme.

DAVID DULLAWAY: *Old Mutual was one of the first large insurance companies to complete its programme, transferring responsibility for fully embedding the regulation to the business much earlier than most. You also came in under budget. What would you attribute your success to?*

ADRIAN THORNYCROFT: There were three important aspects: our approach, our people and tremendous, active sponsorship.

Our approach could be broken down into three main areas. The first is that we spent the time upfront getting a clear a picture of what the end stage looks like. We spent a lot of time and energy creating that end picture. Then, as it was a multi-year programme, we broke it down into stages of between six and nine months. Each of these bite-sized chunks had to be more than just a design; it needed to be a piece of kit available and ready for the business to use. This facilitated some very honest conversations within the team and the business about whether we had achieved what we needed to in each stage and, if we hadn't, why not.

> *"We did a lot of work to get people in the business to understand what to do in terms of their capital and risk position"*

Even within a €100m programme, it is tricky at the beginning when you start spending real money for a small team to sit in a dark room and just think about the end game. It is very easy to come under attack from people within the business asking what that money is being spent on and why they haven't seen tangible results. Our sponsors really stuck with us. Now that we are getting towards the end of Solvency II, insurers that didn't have a clear roadmap are struggling. They now have big infrastructure investments they are having to adjust as they go along. Thinking back to our small team in the dark room at the start of the programme, the resources we were burning then as opposed to now are at a totally different level.

Secondly, Solvency II is a technical space. So we selected individuals and allowed them the space, as well as the accountability and responsibility as the ultimate design authority, to resolve the technical questions. As opposed to a typical programme approach, we had to create space to allow people who are very technical and very thorough enough time (but not too much time) to sit and work through the process, and define the direction of the programme. We found some stars within the business and moved them to a separate team, and then recruited the additional people we needed at an early stage.

The third piece will surprise many people thinking about Solvency II; it was a dedicated effort around culture transformation. We did a lot of work to get people in the business to understand what to do in terms of their capital and risk position. We developed a "use framework", which detailed the various uses of Solvency II within the business. We were quite hard-nosed in laying out the journey ahead of them and made it clear we were going to measure as they went along. We then worked out where individuals needed to get to and helped them through their journey. And if they weren't going fast enough, we helped them more. This process is continuing, particularly as people transition in and out of roles.

Such a project is an enormous drain on people, as well as money. How did you deal with the trade-off between the project and the day job and between internal resources and external support?

You simply can't do something of that size without a big chunk of dedicated resource in the project. There can be no confusion between the people with a day job in the business and the project. But one of the tricks is to get the programme team to understand that the business is going to own it in the end. If the business points out an error, it is the responsibility of the project team to understand the issue and debate the result. But, as a general rule, if there were two ways of doing something, it often

made sense for the business to choose their preferred option, as the ultimate users.

Also, a project needs a clear end and you need to manage towards it. Our use framework was helpful for this. It enabled us to work out who the owners of each individual use were, and to have conversations with them about what they were responsible for once the processes and tools had been put in place by the programme team. Approximately a year before we transferred responsibility for the next stages to the business we had identified the owners and so they had a long time to consult with us before transitions occurred.

As for internal resources, my advice would be to get a lot of internal people, get them in early but, most especially, get the right people. As for external support, consultants are invaluable when you have genuinely hard questions that need answers. For that you need hardworking, bright, capable people who understand the market, and have a wider perspective than you do. By contrast, it is important to be careful what those questions are and to involve the consultants with your internal people in the process. But when you have a very specific, defined job, and you can't find those people internally, it makes sense to go to the contract resource market.

It is well know that Solvency II is a moving feast, with the final rules still to be confirmed. Does this mean it was a risk closing the programme early?

Our top risk throughout the programme was always regulatory risk. That risk still

> *"You need hard-working, bright, capable people who understand the market, and have a wider perspective than you do"*

exists and remains our top risk. We tried to fully understand the risk, and we very clearly communicated our concerns with the various stakeholder groups. There were a couple of cases in point, including contract boundaries and internal model boundary definitions, around which we had lengthy debates. I'm sure some of those positions will have reversed, but what we did was lay the groundwork by making sure there was a dialogue and a decent understanding of the topic. And then we just got on with it.

Yes, there is regulatory uncertainty, but there were also some basics we just had to get going, such as the culture, the tools and the processes. Although some tweaking of the tools or changes in the assumptions may be required, we have the whole organisation up and running.

What were the pros and cons of transferring responsibility for Solvency II into the business so early?

The biggest advantage is that we were able to get the knowledge into the business By working in partnership with the business throughout the programme there was a strong pull (long before we closed iCRaFT) from the business to own and shape the final stages of the programme, which is where the true embedding starts. It meant we avoided any last minute rushes. Typically in a big programme there is a mad panic as you approach any big date, with a rush at the end to get everyone satisfied that they are able to take everything on.

And the cons? I'd say the increase in work for the business teams. When we closed the programme down early, the strong

> *"Our top risk throughout the programme was always regulatory risk"*

partnership that had been created between the programme and the teams, meant the business felt confident enough to move forward without formal support from the programme to truly embed Solvency II. We had many good people, a lot of whom ended up taking their knowledge into the business, which was exactly what we wanted to happen.

The great thing is that the things we put in motion are being bedded in and are being used in the business. By the time we closed the programme, our economic capital model was already in its third iteration. We didn't close the programme arbitrarily; we closed it because the business was in a position to take the own and drive the next stage.

Like most large firms, Old Mutual has taken an internal model approach. Many firms have had trouble implementing their internal models and getting numbers out. That didn't seem to be the case with Old Mutual. Why do you think that was the case?

You make an interesting point about numbers. We wanted to get results out early on the understanding that it would be the next iteration that would, in actual fact, give you the real understanding of your internal model. Now the business has a much more granular and practical understanding of the areas which add value to the business, and those which are additional regulatory requirements, meaning they are better positioned to be able to adapt to ongoing changes in timing.

I think the other thing is we chose tools that were fit for purpose, and delivered what was required, and no more, rather than all bells and whistles.

Now that it is up and running and you are coming up to the approval process, what do you think the biggest challenge you face is in getting this past the last imminent hurdle?

If we are to believe what we hear, perhaps the last hurdle isn't quite so imminent. If it is delayed by a couple of years, I think that is actually the most difficult part. People have dedicated a chunk of their careers and have maintained momentum, but are now simply ready to move on. And I think that's the risk. And again, it goes back to the very first, most material risk we ever had: regulatory risk.

In many firms, and perhaps in the industry as a whole, Solvency II is still seen as very abstract by the management of the business. Do you think senior management at Old Mutual "get it"? And what did you do to ensure they did?

At Old Mutual, we didn't call the programme "Solvency II". Instead it was a capital and risk transformation, and we benefitted from some of the best sponsorship I have ever seen. Beyond this, there were a couple of things in particular that really helped it sink in, one of which was a business simulator. We created, along with Oliver Wyman, a business game[1] that allowed management to "play" the business by quarters, run a series of scenarios, and then see the impact these changes had on the capital and risk position of their business. It was quite difficult to set up in a simple way, but it really helped to make Solvency II tangible to people.

In addition, we surveyed people within the business and tested the level of their knowledge. We split it up according to whether people had a basic, intermediate or advanced knowledge, and if we found some people required more help we found a way to get them to the right level.

In your view, has Solvency II made a difference to the way that Old Mutual manages the business, or is it turning out to be more of a compliance exercise? Are there areas where this new approach is causing problems?

1. For more information see Oliver Wyman publication – ALICE: A Live Insurance Company Experience – Making Solvency II Tangible for Executives

Old Mutual just recently announced that we had hit our debt reduction target. The programme has had a huge impact on the way we talk about our business. In addition, the change to align incentives with risk based metrics was designed to ensure the required changes would be effectively implemented. The conversations about the sale of our US life business were all about risk appetite and understanding the economic capital impact of our decisions. In our Bermuda business, the discussions around our hedging strategy and which options to take and when to close out the five year top-up requirements were driven by conversations about economic capital. The business unit economic profit calculation included a charge for capital actually held at the business unit. Because of their clear understanding of their economic capital, one of our businesses chose to pay an increased dividend to group, thereby improving their economic profit position.

Economic capital tools were also used extensively in deciding on the use of the proceeds from the sale of our Nordic business when discussion centred on the balance

> *"We knew it was going to be a journey when we got the numbers the first time, and we planned for that"*

between debt repayment and special dividend and retention.

What do you think the most important next steps are for companies with regard to Solvency II?

Now with all the delays, I think the most important thing is keeping Solvency II on the agenda, as it risks being deprioritised by businesses. I am concerned that people will have taken it off their agenda, and aren't pushing it so hard, as I think it has huge commercial benefits, particularly in understanding where the risks in the business are at economic capital level and how to fix them. You've got to keep it on the agenda because ultimately businesses can either hold less capital and do something different or it gives them the opportunity to go and explore new business lines.

It is the age old question: where is the pay-off in risk management? For me, Solvency II allows businesses to dig in to where holes could be, examine them properly and critically, manage them to their advantage. And I'm worried that these delays will mean that topic may now come off the table.

ADRIAN THORNYCROFT

Adrian Thornycroft is currently responsible for all change effort across Old Mutual Wealth (Skandia). Prior to this role, Adrian led Old Mutual's iCRaFT (integrated Capital Risk and Finance Transformation) programme between 2009 and early 2012. In this role Adrian developed Solvency II and non-European related regulatory compliance across all of Old Mutual's group companies and transformed the risk culture and capital and risk management across the group. The programme transferred responsibility to the business in early 2012 and was the first programme in the City to do so. The total programme over a three year period was significantly less than comparable peers and delivered into BaU under budget.

Adrian also took on the role of Programme Director for the Group Operating Model between July 2009 and September 2010. He led the implementation of a new governance operating model across all business units of the group, following a series of loses stemming from the financial crisis. His responsibilities involved the design and delivery of the Group Governance Operating Manual, (GOM), establishing Group Head Office into a Strategic Controller model.

Before joining Old Mutual, Adrian worked at both Zurich Financial Services (UK Life) as their Head of Business Change, and previously held the position of Non-Executive Director at MUA Insurance Ltd.

Adrian holds a Bachelor of Business Science degree in Finance and Economics from the University of Cape Town in South Africa.

DAVID DULLAWAY

David Dullaway is a Partner in Oliver Wyman's Insurance domain, based in London. David specializes in the areas of market consistent valuation, Solvency II, economic capital and risk management for insurance companies. He was one of the main developers of market consistent embedded value.

David has assisted many large insurance companies in implementing MCEV, economic capital and internal models (including for Solvency II), and risk management approaches, as well as capital raising and restructuring. He has helped insurance companies develop and implement some of the most advanced approaches to stochastic capital modelling, one of which has become the de facto standard within the industry.

Since joining Oliver Wyman in 2010 he has supported the CEA and CRO Forum on Solvency II, assisted multinational financial groups in developing their risk strategies and risk appetites, led the development of Solvency II compliant risk and capital management approaches, led a number of investigations into the robustness of Solvency II and ICA results, and supported the implementing and use of internal capital models.

Prior to joining Oliver Wyman, David was a Principal at Towers Watson where he led all elements of their global economic capital initiative. Prior to this he was at Swiss Re and Mercer. He has over twenty years of experience in the insurance industry.

David has a first class degree in Economics and Econometrics, and is a Fellow of the Institute of Actuaries.

IT'S A PEOPLE BUSINESS

DRIVING BETTER PERFORMANCE IN P&C CLAIMS MANAGEMENT

INDUSTRY HEADWINDS BRING RENEWED FOCUS ON CLAIMS MANAGEMENT

AUTHORS
Tom Robinson
Prashanth Gangu
Michael Franklin
Connie Baik

The sustained low investment yield environment has forced most insurers to focus their efforts on improving the combined ratio. Historically, investments contributed to 90% of industry profits and as a rule of thumb, most industry professionals targeted a combined ratio of 100 pts. Executives now realize that they need to achieve an overall combined ratio closer to 95 pts to match past returns. In recent times, most companies have launched one or more of three types of initiatives: standard cost cutting programs, improvement in risk selection/adoption of technical pricing, and better claims management. Of these, claims optimization offers the biggest bang for the buck – on average, a 1% improvement in claims costs results in a 10% net income benefit[1]. Additionally, insurers are seeing diminishing returns from cost reduction efforts and find it difficult to adhere to technical pricing in a soft market.

We observe that many claims optimization efforts often fall short of achieving their anticipated benefits. In our view, these failures often stem from an overly narrow focus on the processes and systems for claims management; the people side of the equation is frequently an afterthought. All too often, claims management initiatives do not deliver sustained results because they often do not filter down to the adjusters and the culture in which they operate. What results is a lack of employee engagement and ownership in changes that are pushed through.

CLAIMS IS OUR BUSINESS

Over the last four decades, the claims function at various insurers has gone through multiple "transformation" efforts. While, the specific objectives vary, the general direction has been towards industrialization of claims, i.e., moving away from the historically "artisan" model based on local customization and experience-based decision-making of individual adjusters, and towards a streamlined model with heavy reliance on standardized processes and tools. Broadly, the underlying themes in most claims improvement efforts can be segmented into either workflow or structured adjustments, as seen in Exhibit 1.

While most insurers have obtained positive benefits from these efforts, the impact on the combined ratio has been quite varied, with only a few organizations realizing the full potential. We believe that achieving more substantive and sustainable results requires a more nuanced

1. All figures derived from Oliver Wyman analysis.

EXHIBIT 1: THEMES IN MOST CLAIMS IMPROVEMENT EFFORTS

WORKFLOW	STRUCTURE
• Differentiated claims handling: Better segmentation and triaging mechanisms to assign the right claim to the right adjuster and workflow based on estimated severity and complexity; often supported by predictive tools to prevent fraud • Medical management: Providing timely and effective treatments to deliver superior outcomes • Litigation management: Optimizing the use of legal resources and effective decisioning processes	• Organizational structure: Consolidating functions and locations, and streamlining resources (spans, layers and controls) • Performance management: Setting the right performance goals to effectively steer the claims organization • Systems integration: Automation, rules-based integration platform and data-enabled decision support to allow adjusters to be more efficient and effective • Third party sourcing: Effectively managing the use of external providers to reduce costs while maintaining quality and service standards

approach. Insurers continue to face challenges in obtaining buy-in from the organization to adapt to an industrialized approach. They often lack a strategic and systematic approach to developing the talent pool that is required to create a high-performing claims function.

The gains required to offset the industry headwinds described earlier require a greater focus on empowering and developing claims professionals, whose collective actions shape important customer perceptions and drive bottom-line results.

TAKING AN INTEGRATED PERSPECTIVE

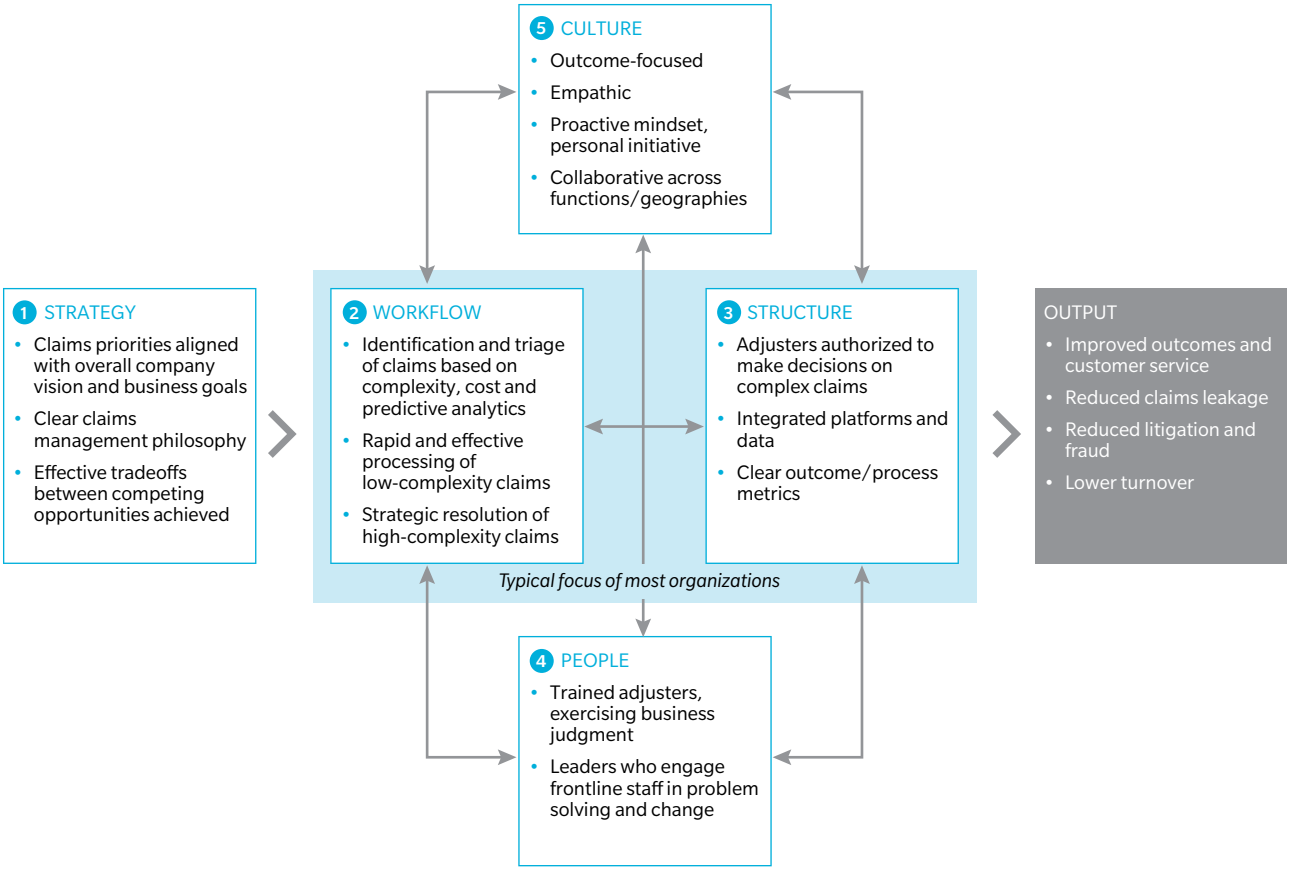
We observe a range of claims management practices in our work for insurers globally. The common denominator among insurers with strong claims management capabilities is that they strike the right balance between the "hardware", such as workflows and systems, and the "software", the people and culture. That is, they use technology, claims workflow processes, and the formal reporting structure to support rather than replace the expert judgment of their claims professionals.

Bringing all of these elements into alignment requires an integrated perspective on the claims function. Our recommended approach is to think of the claims function as a system, consisting of interrelated strategic, technical, and social subsystems (see Exhibit 2).

The claims function is composed of four essential components: *workflow, structure, people, and culture*:

- **Workflow** refers to the inherent processes that need to be carried out by the claims function
- **Structure** consists of the formal organization, systems, and metrics that help leaders and individuals perform required tasks
- **People** includes the characteristics and capabilities of the individuals within the claims function
- **Culture** includes behavioral norms, patterns of influence, and communications.

EXHIBIT 1: A BLUEPRINT FOR CLAIMS MANAGEMENT



Source: Oliver Wyman

Ultimately, the purpose of the claims function is to deliver on the claims management strategy. However, the degree of alignment between each component will determine the claims function's ability to effectively meet its objectives. While it sounds simple, maintaining the "fit" between these four components is incredibly difficult.

Typically, claims functions are overly preoccupied with the workflows and the *formal* organizational structure. This focus is the primary cause of failure of claims transformation projects. Improving claims functions requires a more holistic approach that addresses culture and people, as well as the workflows and systems. Overall, adjusters must be able to think strategically about how to best resolve claims, relate to claimants, and take appropriate, outcome-oriented decisions. This necessity requires a change in perspective from leadership in how they view culture, talent and organizational structure as essential elements in any change plan.

A BLUEPRINT FOR CLAIMS MANAGEMENT

1. STRATEGY – PHILOSOPHY AND PRIORITIES

Clearly, the right blueprint begins with a well-defined claims management strategy and philosophy that is aligned with the overall corporate vision and business goals.

For most insurers, claims strategy starts with the principle that effective claims management is about identifying and resolving claims in a way that delivers quality customer service and manages costs. There are three basic components to this claims philosophy:

1. Adjudicating claims and paying the fair amount
2. Getting to resolution in a fast, cost-effective manner while tending to customer needs
3. Performing analysis required to send the right signals back to the rest of the organization (marketing, actuarial, underwriting, loss control, and premium audit) to help guide and refine the overall company strategy

At the same time, there is a balance between competing priorities that must be clearly communicated throughout the claims function. At its heart, strategy is about making choices. While there may be dozens of urgent projects in the pipeline, it is essential that the strategy provide focus to these efforts. The strategy governs the time and resource decisions for leaders, managers, and staff and it must clearly define what those priorities are and enable effective tradeoffs between competing demands. Without that discipline, even a well-engineered organizational system will buckle under the weight of too many projects and unrealistic expectations.

2. WORKFLOW – TRIAGE AND RESOLUTION

Claims functions must optimize the tradeoffs between loss payouts, loss adjustment expenses, and customer satisfaction. Managing these tradeoffs requires appropriate decisioning, informed by the right data and accurate predictive capabilities.

Most insurers segment claims based on expected severity and complexity. This approach allows them to settle a larger portion of their claims closer to the optimal settlement outcome. However, many insurers still lack a thorough understanding of their quantitative performance against best possible service, speed and settlement. This necessitates continued investment in an adaptive triage process using predictive analytics to fine-tune claims segmentation.

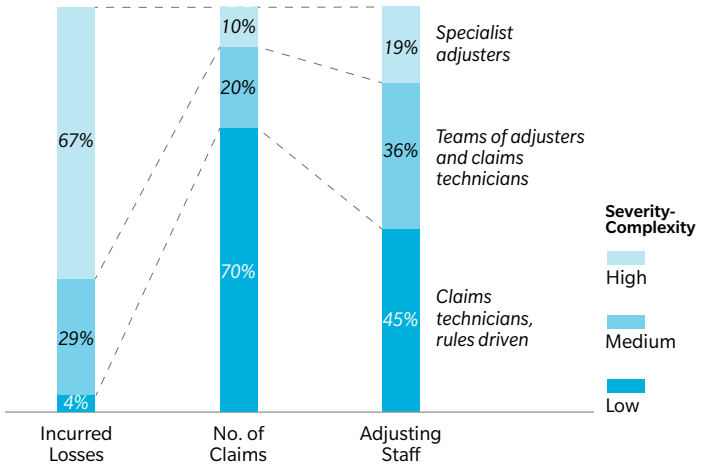
However, model-based triage is only the first step. The organizational system needs to be structured to support different claims handling processes and the funnelling of cases to individuals with appropriate skill levels. Ideally, low severity-complexity claims should be quickly identified, segmented and addressed using standard procedures and rapid processing. More complex claims should be directed towards adjusters with the appropriate skills and experience. High severity-complexity claims that can be influenced and managed through skilled intervention should be directed into a highly skilled group of specialist adjusters for detailed review and strategic decisioning. This kind of optimal segmentation and resourcing requires more than triage algorithms and a few workflow diagrams; to successfully execute these processes, the claims function must also place the appropriate amount of decision authority into the right hands at the right time.

3. STRUCTURE – ENABLEMENT AND METRICS

While they aren't magic bullets by themselves, changes to the structure of an organization might also be necessary to support the overall direction of the claims function. This may involve making adjustments to elements such as the reporting structure, decision-making rights, settlement authorities, systems, and performance metrics and targets.

In a typical claims function, the top 10% of claims make up the lion's share of incurred losses (see Exhibit 3). The consistency and business judgment of claims adjusters working on high-risk claims are major factors in insurers' ultimate results. Formal reporting lines and authorities need to be structured so that decisions are directed into the hands of those adjusters best able to make the critical calls these claims require, while oversight is retained. Maintaining this balance of adjuster independence and appropriate governance needs an in-depth look at the critical decisions that are being made on high-risk claims and structuring the approval process accordingly.

EXHIBIT 3: ALIGNING THE ORGANIZATION WITH CLAIMS COMPLEXITY



Source: Oliver Wyman analysis

In order to get the right information into the hands of those making these decisions, systems need be streamlined; having multiple systems often means that people must look high and low for the right information. Integrated, end-to-end platforms that allow rules-based decision-making supported by historical data and predictive tools are a key step in minimizing claims leakage and improving customer service and speed.

Metrics and targets should be developed as another key organizational lever, starting with overall claims management goals followed by their translation into performance metrics for claims executives, supervisors and line adjusters. By engaging front line managers and some staff in this process, these metrics become a yardstick of success and improvement that have real meaning for the people doing the work and drive consistency throughout the organization.

Implementation of such quantitative targets can often be a challenge. Concerned by the possibility of lawsuits, insurers have struggled to legitimately tie adjuster compensation to overall claims outcomes. The ultimate destination is likely a clear linkage between financial incentives and quantifiable claims leakage (both under and over payment on claims). In the meantime, we have seen insurers successfully apply non-monetary incentive mechanisms such as token rewards, recognition from senior leaders, and celebrating "the stories" that exemplify the right choices.

The workflows and structures are often where claims management improvement efforts start and finish for many insurers. When change is necessary, many leaders automatically reach for the organizational chart, move the boxes and lines of the formal reporting structure around, and perhaps assess process efficiency and workflows or invest in new systems. There is often a feeling of satisfaction among leadership

once these changes are implemented, but a few months later, many may wonder why little has changed at the front lines. Results may improve for a period of time, but then regress once the next change or metric takes away the focus. This can be frustrating to leaders. With so much investment in process efficiency, tools, and organizational structure, why aren't changes resulting in consistent improvements?

In order to cement the effects of these initiatives and deliver sustained results, process and formal organizational improvements are not sufficient on their own – the people and the culture also need to be engaged and aligned with the strategy.

4. PEOPLE – THE PROBLEM SOLVERS

People drive best-in-class claims management. The actions and judgments of individual adjusters impact the outcomes for customers and the company.

Unfortunately, the insurance industry has had significant challenges in recent years in attracting the right talent into claims organizations. Most insurers rely on the same dwindling pool of experienced adjusters, trying to retain or poach these individuals from other organizations. Some of the difficulty in attracting new talent may come from the perception that claims management requires checking one's independent thinking at the door – deferring to dogmatic processes without much ability to exercise intelligent or decision-making. We see this notion reflected in popular culture: in *Double Indemnity*, a 1944 film noir directed by Billy Wilder, Edward G. Robinson portrays a claims adjuster who tenaciously pursues the facts surrounding a suspicious insurance claim. By contrast, the 2004 animated comedy *The Incredibles* uses Bob Parr's humdrum life as a claims adjuster as the antithesis of his earlier exploits as a superhero.

ASSESSING YOUR ORGANIZATION – DIAGNOSTIC QUESTIONS

Insurers should assess the degree to which their claims functions are aligned with their overall corporate strategy. To start this assessment, we suggest conducting a short diagnostic exercise across the key components:

STRATEGY

- Is your claims management strategy and underlying philosophy defined and aligned with your company strategy?
  Are the priorities and tradeoffs clear?
- Has the strategy been communicated to leaders, management, and the front line staff?

WORKFLOW

- What are the key segments of work for your business?
- Do you effectively segment claims by complexity and route those claims appropriately in the organization?

STRUCTURE

- Are decisions being made with people at the right level and with the right authority? Are the right people empowered to make critical decisions for high risk cases?
- How do you track and measure performance? Are metrics consistent with the strategy and performance and reward systems?
- Do you have the right tools and systems to support the critical work and decision-making processes for your business?

PEOPLE

- Do you have the right skills and capabilities in leadership to support your strategy?
- Where are there talent and capability gaps?
- Are your front line staff engaged in raising issues and solutions?

CULTURE

- How would people describe the culture and sub-cultures of your organization?
- Does the culture of your organization support your strategy? Is it aligned with the work people are doing in claims?

This diagnostic offers a starting point for a company looking for sustained performance improvements. However, identifying the areas where the "fit" will need to be adjusted is just the beginning. An organization needs to implement changes in a coordinated and consistent way to realize their full value.

In reality, career claims adjusters often see their craft as an art, involving creative problem solving and fast decision-making. Adjusting is a constant balancing act that has real impact on real people, every day. For complex cases, there is no company manual or process diagram that can point the adjuster to the right choice – this is where business judgment based on insights gathered from thousands of cases drives the best decisions. The general trend of lower frequency and rising severity coupled with the challenging tort and medical environment only increases the need for these skilled adjusters.

Unlike changes in processes or systems, which may be one time, developing and training a skilled claims staff requires sustained focus and investment from leadership. It can be difficult to maintain this focus, especially under staffing pressures that may force managers to place less-than-ideal candidates in positions where their decisions impact customers.

Developing people who appreciate the real art of adjusting requires the right recruiting messaging and selection process, quality training and reinforcement, and clear development paths that reward the contributions of individuals.

In one real-life example, an insurance company was reviewing its homeowners' book and was surprised by the loss ratios it was seeing, which were much higher than in past years. The losses were traced back to a new group of adjusters, who, recently out of school, were all renters and had little idea of the issues facing actual homeowners. They were following procedure and checking the boxes, but they fundamentally didn't understand the right questions to ask, leading to critical gaps in initial claims assessments. Results only improved once the company moved more experienced adjusters into the staffing pool with the right backgrounds and skills to relate to their clientele.

Developing people who understand and appreciate the real art of adjusting is critical to effective claims management. It requires the right recruiting messaging and selection process, quality training and regular reinforcement, and clear development paths that reward and celebrate the contributions of individuals.

In turn, retaining these skilled adjusters requires developing leaders who support, motivate, and engage their staff. As the organization becomes more sophisticated at identifying general claims issues and managing them using a systematic approach, managers will increasingly spend their time addressing new problems and more complex issues that may not have had sufficient attention in the past. They will need to call upon the expertise and experience of the front line adjusters in recognizing these issues, bringing them to the fore, and coming up with solutions. For some organizations that currently run in a command-and-control environment, this may be a new set of expectations and behaviors. Managers who have been successful in the past may not have the skills or desire to engage people in the change. Ultimately, the right culture is critical in driving these behaviors and in motivating managers to think about engagement in a different way.

5. CULTURE – DOING THE RIGHT THING

The claims management culture needs to motivate and drive the right attitudes and behaviors for the individuals in the

organization, from top leadership to the newest staff member. When people say they are doing "the right thing," how do they know what that is? In each environment, the answer may be very different; an employee in one claims department may say the best action is to "wait and see", while the same employee in the same situation at another organization would say "we have to escalate and get it resolved now."

One example of "doing the right thing" was recently raised at a company meeting of adjusters as a case exemplifying the ideal culture of that company. There had been a workers' compensation case involving an accidental death. It was a complex matter, one that would typically have taken a few months to resolve. The widow of the insured was in difficult circumstances and desperately needed some financial relief for her family. She contacted the adjuster, hoping to get help.

This was a major decision point for the adjuster. While some might have said "there is nothing we can do – it's too complex and you'll have to wait until we sort it all out in our processes," this adjuster wanted to do more. She listened, had empathy for the problems the widow was facing, and acted – assembling a team of attorneys, managers, and investigators to complete the discovery and make a decision quickly. Within two weeks, the widow had the check she was entitled to and could move on to helping her family through their grief with a little peace of mind and security.

Some claims functions find themselves locked in a reactive mindset, allowing complex issues to sit until they reach a critical point or gather until the system is overburdened. All too often, issues sit in organizational silos, passively waiting for a request from another part of the organization before decisions can move forward. The culture set by the top leadership is what drives this behavior. Ideally, the culture of an effective claims management organization values and has empathy towards the customer who is impacted by its decisions, rewards personal initiative from its people, and has a collaborative mindset in accomplishing its goals where there is joint responsibility for outcomes. All of these qualities support and motivate high-performance behavior, motivating skilled adjusters to act and reach out when more information or context is required to get a better result.

CONCLUSION

The challenge of balancing the components of the organization lies in the need to achieve flexibility and autonomy of decision-making at the claims frontline while maintaining discipline and focus on fair outcomes and costs.

What differentiates successful companies is that they recognize the inherent interdependence of each element in claims management—the capacity for each part to strengthen and sustain the others. They engage the leaders and front line employees in driving real change, explicitly adhering to the organizational structure.

A focus on any one system component in isolation is unlikely to yield dramatic, long-term results. However, weaving them together across the claims function, rather than treating them as sporadic initiatives, should lead to sustainable improvements.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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