



Insights:

## The strategic dimension

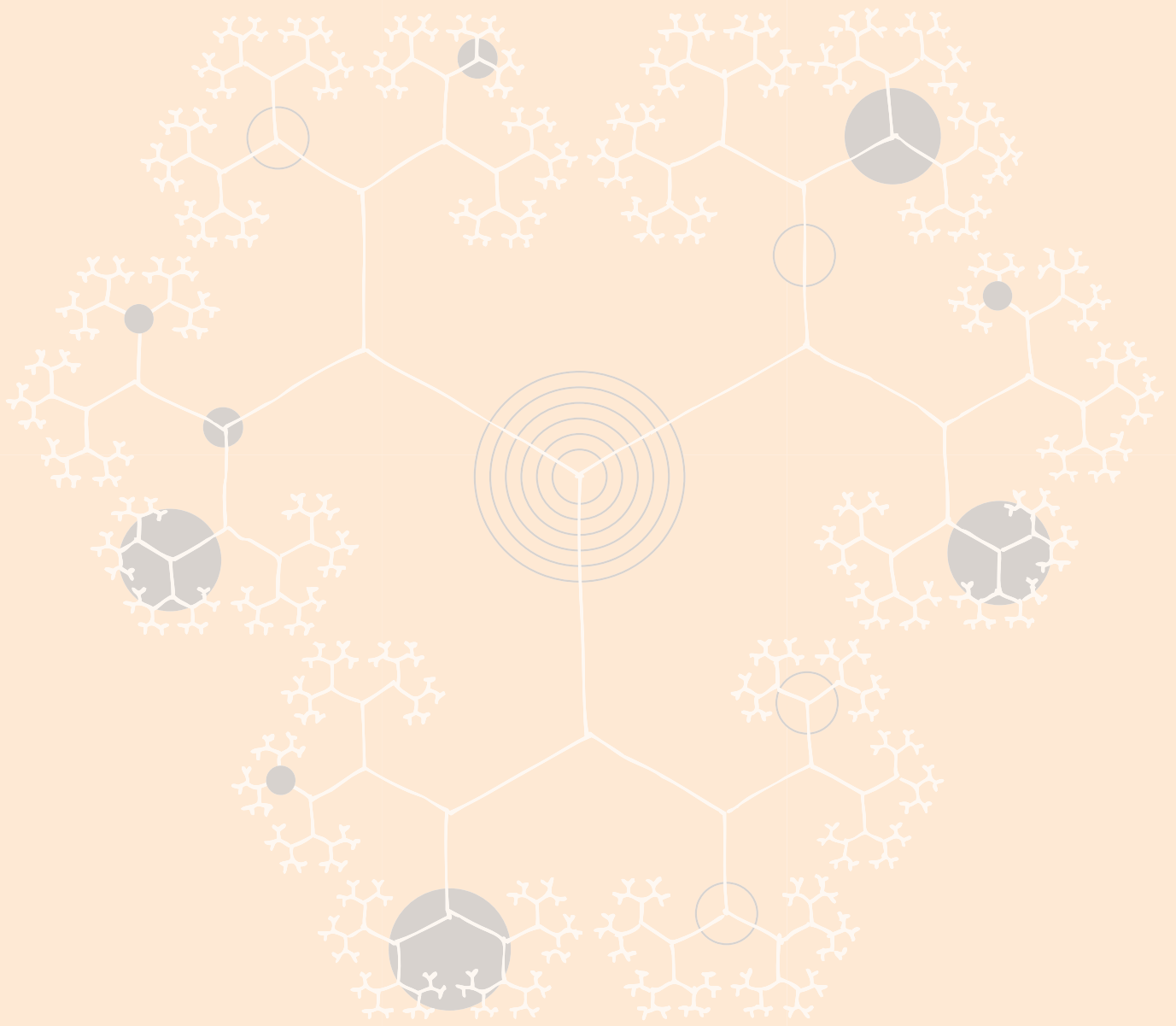
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With focus still very much on profit, attracting and retaining the most profitable customers is fundamental. By combining multi-factor quantitative techniques with qualitative research, companies can robustly predict – and influence – customer behaviour.

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The RDR in 2010: a step forward or another turn on the merry-go-round?

The Retail Distribution Review has yet to be finalised and, at the time of writing, we are awaiting further FSA announcements and another Policy Statement during March 2010. The uncertainty is compounded by the possibility of a new government. However, the industry has to continue to move forward, despite these uncertainties.

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The preparations for Solvency II legislation in 2012 are gaining pace. While there is still debate on the details, the fact is that the level of solvency capital that insurers hold, and the form in which it is held, will change. This has strategic implications in terms of product and growth strategy.

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Equity release: is there a future?

The last decade has witnessed strong sales growth for equity release and yet the total market size is only a tiny percentage of its potential. With individuals having a greater need to self-fund retirement, and with the proportion of household wealth tied up in equity, it is troubling to see major players leave the market.

By Sandra Gabriel



# Portfolio maximisation

## making the most of your in-force portfolio

When we talk about ‘persistence’, ‘surrenders’, ‘in-force retention’ and so on, it is easy to lose sight of the fact that we are actually talking about people simply deciding whether or not to keep paying for something.

Measuring and monitoring statistics in this area is different from other actuarial calculations as it is not about measuring tangible, uncontrollable events such as deaths or having a car crash. We are talking about people’s behaviour which is more subtle and – more importantly – the outcome can be influenced. The key is therefore to understand this behaviour.

Consumer behaviour is “the process and activities people engage in when searching for, selecting, purchasing, using, evaluating, and disposing of products and services so as to satisfy their needs and desires” (Belch and Belch). The study of human behaviour incorporates psychology, sociology, social anthropology and economics. It looks at demographics, behavioural variables and influences on individuals that inform the buyer decision-making process.

With the current economic climate and internal pressures, retaining existing customers is paramount. There are three facts worth highlighting with regards to how we relate to customers in the current environment:

- Consumers are likely to be more resistant to approaches by providers. Providers are more cautious in their spending. Therefore, customer acquisition activity needs to be as efficient as possible.
- Existing customers are cheaper to keep than new customers are to acquire.
- It is cheaper to market to existing customers than to market externally.

The key question is how can you hold on to existing customers, maximise the value from them and more effectively target new customers?

The solution is to improve our understanding of customer behaviour and to apply that understanding to increase the profitability of existing customers (the in-force portfolio).

Traditionally organisations have used simple 'one-dimensional' techniques which provide little useful information. Recently some insurers have started to use 'multi-dimensional' techniques such as generalised linear models (GLMs). Such models allow a number of factors to be analysed simultaneously. The factors can include data held by the provider such as customer age and policy duration, as well as externally available data such as geodemographic, lifestyle or investment market data. GLMs identify the true effect of such factors on policyholder lapse/surrender, allowing for all correlations between factors and removing the 'noise' caused by random fluctuations.

This technique has been used in the non-life markets for several years. However, for many providers of life insurance, this technique represents a new generation of customer modelling. A very useful output from these models can be a single-figure score which will represent, for every customer, his or her propensity to surrender.

The use of GLMs is a great step forward. They will quantify all that can be quantified, and from this analysis we can learn what the behaviour seems to be (for instance that customers in a certain postcode or from a particular sales channel exhibit an unusually high surrender rate) but we do not yet know why. To know why customers are behaving as they are we need to conduct consumer research. For example, we could identify the 10 per cent of customers who are the most likely to surrender; complete qualitative (and possibly quantitative) research with this group; establish the reasons for historical surrender; infer the reasons for possible future surrender; and then implement preventative measures to minimise surrender.

The combination of multi-factor quantitative research and focused qualitative research can allow companies to robustly predict customer behaviour. This can help to reduce surrenders, thereby maximising value from existing customers.

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# The RDR in 2010

## a step forward or another turn on the merry-go-round?

2010 could be a year of clarity, where the industry makes significant steps to move towards embracing the Retail Distribution Review (RDR), or it could be a year of frustration, where certain elements of the RDR are reconsidered by a change of government.

The Financial Services Authority (FSA) issued Consultation Paper CP 09/31 in December, which addressed professional standards, consultancy charging in corporate pensions and whether to 'read across' elements of the RDR to the 'pure' protection market. To supplement CP 09/31 on these areas, the FSA is due to issue its Policy Statement (PS) on the RDR during March 2010. The industry should, therefore, be set to move forward with more confidence during 2010, working its different ways through to the 2012 deadline.

As a result of the above papers (CP and PS), the industry – from product provider to adviser – may be able to pin-down some of the currently lesser-defined aspects of the RDR, which generate significant press speculation and comment, including:

- Can the advice gap of the mass-market be addressed through 'simplified advice processes'?
- What will (or will not) be allowed in terms of 'factoring'?
- How does adviser charging work in vertically integrated organisations, such as the banks?
- What is the specific content of the level 4 exams and how might CPD 'gap-filling' be achieved?

So what can derail progress on the RDR?

A widely held view is that a change of government will result in a change of direction, either for the FSA as an organisation, or specifically for the RDR.

Various members of the Conservative party have made statements over the last few months, specifically Nigel Waterson MP, shadow pensions minister, who has questioned whether the EU was pro-commission and whether this might result in a rethink of the adviser charging proposals. He also questioned whether the ability to pass examinations should take precedence over industry experience, bringing into question whether grand-fathering might be re-introduced.

However, Mr Waterson also said his party was committed to the RDR and while, if elected to government, it would scrap the FSA, and hand over control of implementing the review to the new body created to regulate IFAs.

Increased professionalism, clearer charging structures and the removal of commission and its associated bias have received near universal support in terms of the principles from disparate audiences in the industry. Although the name of the regulating body may eventually change, the drive to address these aspects was made patently clear by Sheila Nicoll, director of the conduct policy division of the FSA, when she spoke at the TISA annual conference in November 2009: "We remain committed and resolute in addressing the problems we see persisting in the market and in our approach to dealing with them".

Irrespective of the 'tweaks' to the foundations laid within the RDR by whichever party is in government, the industry must be prepared to take 'no regret' decisions in 2010. To wait and see whether the merry-go-round turns again is a high risk strategy. Instead, action needs to be taken to ensure that providers are confident in:

- Their customer segments and engagement strategies post-2012.
- The channels they wish to distribute through to reach these customers.
- Products that meet the needs of the customers and have appropriate pricing, for example, product charges with a separate facility for adviser charges.
- Their marketing material and communications are clear and reflect any changes in terms of target customer or product benefits.

Those that fall behind now face a challenging run up to 2012. 2010 must be a year of action and progress.

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# Solvency II

## the strategic dimension

You would have to be fairly well insulated from the outside world to have missed the discussion and preparation for the introduction of Solvency II legislation in 2012, particularly with its potential impact on UK annuity business. Although fundamentally a prudential supervision and financial exercise, the ramifications are very much strategic and need to be appreciated by all involved in strategy, marketing and product areas.

Based loosely on the Basel II three-pillar approach, Solvency II is intended to produce a more consistent solvency standard across insurers and across the European region while also delivering capital requirements that are more reflective of the risks being run by individual insurers.

There is still debate and lobbying around various elements of this initiative, but the fundamental is fixed – the solvency capital that insurers hold, and the form in which it is held, is set to change, and this has far reaching implications.

Because the level of capital is directly influenced by the type and volume of products that an insurer writes, it follows that decisions regarding product markets also directly influence capital. This of course is not new. What is new is that Solvency II is set to change capital requirements on a product by product basis, which, at a stroke, will change a company's capital position and hence profitability for better or (more likely) worse. Considering product strategy in a 'Solvency II world' is therefore a key business decision.

However, decisions are not only about capital on a product by product basis. There are risk diversification benefits to be had, for instance in balancing mortality and longevity risk between protection business and annuities, where increasing life expectancy has opposite effects. Achieving this position may be about which products to include and to what extent, but for multinational insurers it's also about where product lines are written to ensure that these types of complementary products are in one jurisdiction and can be offset. This may have, in part, driven recent moves to centres such as Dublin and Luxembourg. Companies will also need to reflect on the relative competitiveness of groups headquartered inside and outside the European Economic Area (EEA).

Furthermore, all these considerations also apply to potential acquisitions. The financial position of a target organisation now will almost certainly change as a result of Solvency II, both on a standalone basis and potentially on a merged basis as it enhances or detracts from any existing diversification benefits. In fact, this may be the feature that drives acquisition strategy.

Companies can be leaders or followers. Those that move quickly to define alternative strategies, even with imperfect information, will be well positioned to test them under differing scenarios which will inform both lobbying and implementation planning. Insight and early decisions could lead to fine tuning or redesign of products and securing distribution ahead of those that wait for the certainty of finalised legislation, which will not come until 2011.

The considerations are therefore significant. Companies need to assess whether the capital position of their products is affected by Solvency II changes, if so by how much and whether any negative impacts can be mitigated through rebalancing, or seeking diversification benefits through changing the product mix or with new additions.

Driving sales growth, developing new products or entering new markets (not to mention corporate restructuring) are not quick fixes, so developing effective strategies and starting early can deliver significant competitive advantage.

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# Equity release

## is there a future?

In a simple world, equity release would be an ideal product to complement pensioners' funding needs during retirement. However, the success and reach of equity release in the United Kingdom has been modest and its future is uncertain.

It is no surprise that demographics are changing. The population is ageing and people are living longer and healthier lives. Recent research suggests that more than half of the babies born today in rich countries will live for 100 years, with earlier diagnoses and better medical treatments contributing to extend the life span.

Although an increased life expectancy should be cause for celebration, it has complex associated challenges that give rise to concern. Individuals are and will continue to live longer in retirement.

The state pension is too low to provide an adequate and comfortable life during retirement and as employers replace Defined Benefit (DB) schemes with Defined Contribution (DC) schemes, there is an increased responsibility on individuals to ensure that they will have a reasonable level of savings (pensions or otherwise) to fund retirement.

Although some people are accumulating a respectable pension pot (whether DB or DC) for their retirement, a significant proportion are not. The Association of British Insurers estimates that approximately 10 million individuals are not saving at all, and therefore will depend on state benefits or other accumulated assets for income in retirement.

Around 40 per cent of the total net wealth of UK households is in residential property, with a vast proportion of such housing assets held by people approaching or above state pension age.

Equity release was identified as a mechanism to tap into this enormous source of assets to provide an income to support those in retirement. Yet despite generally strong growth in the market over the last decade or so, there remains significantly untapped potential. Only approximately 1 per cent of net housing wealth held by UK pensioners has actually filtered into the equity release market.

Given the apparent potential of this market, one would expect companies to be queuing up to enter, but instead we have seen a number of exits in recent months.

The impact of the financial crisis is clearly a factor, as well as an increasing focus on the need to rationalise and optimise the use of capital.

There is however an enormous prize at stake for those that can come up with innovative, capital-efficient solutions which are attractive to – and well understood by – consumers approaching, at, or in-retirement. Perhaps then the market will begin to realise its true potential.

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