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The Future of Life and
Pensions
Life-saving Solutions



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THE FUTURE OF LIFE AND PENSIONS

Life-saving Solutions

The life insurance industry is set to become the next victim of the credit crunch: so say the doomsayers. Life insurers' exposure to global equity markets, commercial property and corporate bonds – asset classes which have suffered heavy falls this year – has had a severe impact on balance sheets. Recession brings with it an increased risk of corporate bond defaults which will further impact balance sheets. And there are other pressures, too: changes to the capital gains tax regime and increased competition from cash deposits could also impact the bottom line. Some insurers will have to raise fresh capital, while smaller and weaker players will almost certainly face the threat of takeover.

But the outlook is not as poor as it may at first appear. Booz & Company believes that many players will prove resilient. There have been some ratings downgrades this year, but there have also been a couple of upgrades. Past performance of European life insurers also gives cause for optimism: the share prices of life insurers have proved less volatile than those of banks in the past, underperforming during growth periods but outperforming when markets are falling.

Booz & Company believes that a fundamental set of trends are affecting the industry.

Players that manage to reposition themselves in response to these six key trends are likely to benefit disproportionately from current market discontinuities. Aggression and radical action will, in some cases, be required – unusual behaviour for life and pensions businesses.

Exhibit 1

Life and Pensions Market – Six Key Trends

1	Changes in competitive environment: scale or specialization?
2	Shift towards asset management
3	Mature markets increasingly unattractive
4	Changing customer needs and Treating Customers Fairly (TCF)
5	Emergence of new distribution models and new technologies
6	Transforming operating models, execution and culture

Source: Booz & Company analysis

1. Changes in the competitive environment: scale or specialization?

With new entrants such as portals and retailers joining the market and the distressed assets of businesses damaged by the credit crunch up for sale, now is the moment for insurers to make a clear strategic choice: do they wish to position themselves to capture the benefits of scale, or to pursue specialization? Those players who currently occupy the middle ground will have to make acquisitions or position themselves for takeover.

The pursuit of scale is not straightforward, however: in the past, consolidation and acquisitions have delivered size, but not necessarily scale. Insurers will need not only to target traditional integration objectives, such as ensuring business continuity and migrating future business; but also more ambitious goals - including shifting in-force policies, both open and closed. They will also need to address the issue of rationalising legacy systems and eliminating sources

of complexity. The Lloyds TSB – HBOS integration of life businesses will be an interesting example to watch, as their approach to capturing synergies is likely to set a new, more radical tone in the industry.

While increased specialization has been a key industry trend over the past 10 years – in 1998 55% of UK players followed a diversified approach, compared with 33% today – it is Booz & Company’s view that specialist players risk becoming increasingly marginalised in the current environment, as national and European scale players emerge.

2. Fortune favours the brave: moving into asset management

A shift towards asset management may seem highly counterintuitive given the state of global equity markets; however, over the longer term those players who take bold steps into the sector may be richly rewarded. Booz & Company forecasts the compound annual growth rate for the asset management industry between

2006 and 2017 will be around 6%, compared with less than 4% in life and pensions.

A number of key trends reinforce the prediction that asset management will be the fastest growing business line. These include the increased wealth and greater sophistication of many emerging markets, changes in demographics leading to longer periods of asset accumulation and the shift in responsibility for healthcare and pensions from the state to the individual.

Some traditional insurers have already repositioned themselves as asset managers: Allianz, for example, took over both Pimco advisors and Nicholas-Applegate in 2001. AXA acquired Framlington Group in 2005 and established joint ventures with SFDB and Shanghai Dragon in China, as well as Bharti Enterprises in India last year. Other players will need to follow suit if they wish to exploit the long-term growth in funds under management.

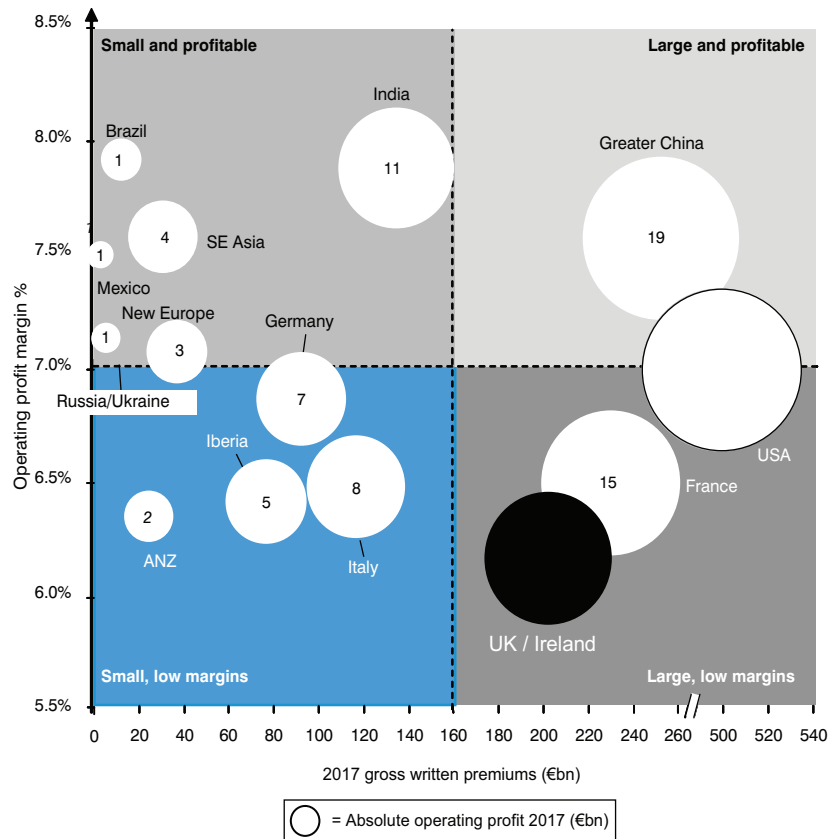
3. Looking east: growth to be found outside mature markets

The best performing insurers already have a strong presence in Asian markets. Prudential, for example, has a presence in 13 Asian markets which generate more than half of new business profits; and it is looking to grow its Asian business further, possibly through the acquisition of AIG’s considerable assets in the region. ING, which has taken stakes in Indian, Chinese and Thai banks, earned 48% of its new business profit from Asia last year, while AXA’s new business profit from Asia was 33%.

There is a strong case for continued investment and

Exhibit 2

Projected Life and Pensions Profit Pools 2017¹



1. Projected pre-tax operating profit

2. US profit pool not to scale

Sources: ABI; LIMRA; Swiss Insurance Magazine; Axco; CEA; Swiss Re; Booz & Company analysis

expansion in Asian and other developing markets. Booz & Company predicts that by 2017, the highest margins in the life and pensions business will be found outside mature markets: in China, India, south east Asia and Brazil, profit margins are forecast to be 8%. By contrast, in most western markets, where competition is fierce and distribution networks firmly established, margins will be thinner – most likely around 5%.

Growth in emerging markets will need to be explored – balancing short-term with long-term opportunities. Short term, there is clearly value in riding the wave created by the current downturn.

Longer term, there will be growth opportunities in emerging markets, such as the BRIC countries. These will require in-market ‘know who’ as well as ‘know how’.

4. The third way: customer needs come to the fore

Demographic changes, as well as more challenging economic environment, will have a significant impact on the kinds of products that customers need. Volatile equity markets create a greater demand for structured products with built-in guarantees to cap the potential downside. Increased longevity means customers will

be forced to work for longer and will therefore have longer periods of asset accumulation, but draw down periods will be longer too. In addition, as life expectancy increases there will be a growing demand for long-term care products and more flexible annuity and draw down arrangements.

The retirement income market in the UK, currently worth £12 billion a year, is set to grow to £18 billion a year by 2012. Of this, a growing share should be made up of ‘third way’ products that fall in between the traditional poles of annuities, which provide a guaranteed income but no prospect for capital growth, and draw down products, which offer growth but no guarantees.

Increased pressure to focus on customer needs comes from regulatory initiatives such as the Financial Services Authority’s Treating Customers Fairly (TCF) scheme, which places greater onus on firms to deliver appropriate products, suitable advice and clear information to their end-customers, and the Retail Distribution Review (RDR), which aims to simplify – and clarify for consumers – the way in which financial products are bought and sold.

In response to these trends, insurers must become more end-customer centric. In order to benefit from the 50-plus opportunity, for example, a shift from a ‘product-forward’ to a ‘market-back’ approach is required. The best performers will deploy sophisticated customer segmentation, tailored marketing, sales approaches and products, as well as smarter packaging based on increased risk appetite and strategic pricing.

5. Techno-advice: looking further into the future

While current debates over the way in which financial products are sold in the UK hinge on initiatives such as RDR, forward-thinking insurance providers should be considering the longer term future of distribution.

There are two key trends to consider: first is the value shift towards distributors. In most of Europe, distribution is dominated by bancassurers; in the UK, however, independent distributors such as IFAs currently make the lion's share of sales. With commissions rising, they are capturing a larger share of value, too: between 2000 and 2005, manufacturers saw profits

grow by 16% to 17%; IFAs saw commissions grow by 23% to 25%. Moreover, IFAs own client relationships, they have critical access to market information and are the players best placed to benefit from cross-selling.

While there could be a value shift back to manufacturers as RDR starts to produce results, there remains a strong case for insurers to gain a greater share of distribution by investing in direct sales forces and gaining access to bancassurance.

The second trend is the emergence of remote advice delivery, which could happen sooner rather than later: HSBC is already trialling

a remote advice delivery system using video conferencing. Video conferencing, which is expected to hit the mass market within five years, will be used in the affluent and mass affluent segments much sooner. This will transform the way in which advice is delivered to the customer and significantly improve the economics of customised advice delivery.

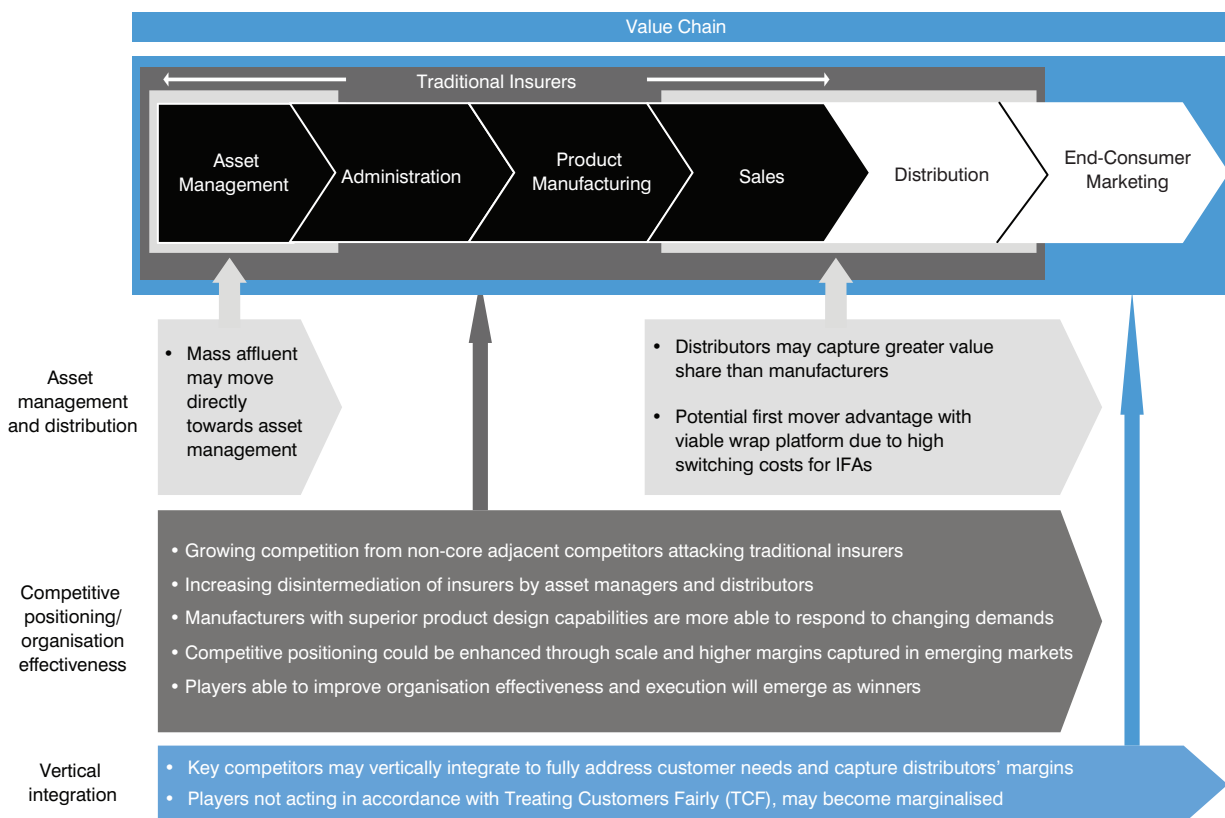
Bancassurance and technology-enabled direct channels therefore emerge as major opportunities for insurers to capitalize on.

6. Culture shock: transforming operating models

Life and pensions companies are slow-moving beasts – as befits

Exhibit 3

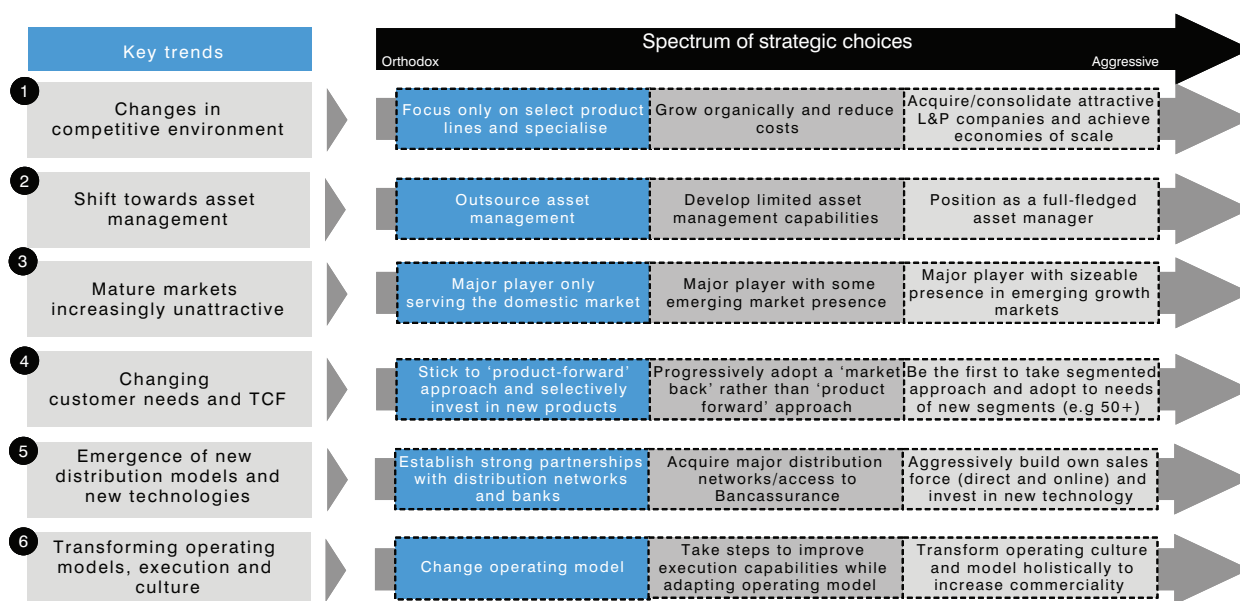
Impact of Key Trends on the Life and Pensions Value Chain



Source: Booz & Company analysis

Exhibit 4

Key Questions and Strategic Choices for Insurers



Source: Booz & Company analysis

industries where mistakes may not be felt for many years. Some companies have used this as a cover for inactivity: it is not until recently that they have felt significant pressure to transform their operating culture in order to maximise profitability. Booz & Company's Org DNA profile identifies almost 23% of UK insurers as 'over managed', while 40% have a 'passive aggressive' culture: while the organization seems consensual, in reality accountabilities are not enforced and governance is cumbersome, resulting in slow and second-guessed decisions.

In some areas the comparisons between benchmark strong execution companies and insurers are shocking: for example, 97% of benchmark companies agree that important strategic and operational decisions are quickly translated into action, compared with just 31% of insurers; 55% of benchmark companies say

information flows freely within and between departments compared with 20% of insurers.

If insurers are going to deal with the key trends noted above, if they are to become more customer-centric, to embrace new technologies, develop new products and exploit new markets, they must improve their execution capabilities and operating culture. The first step is to identify barriers to execution and the root causes of execution failure; the second to come up with an improvement strategy. The third, and most challenging, step is to shape an operating model, enhance capabilities and embed new ways of working in order to deliver the future business strategy.

Next steps

The traditional insurer operates within a small segment of the value chain, covering administration and product

manufacture: that needs to change (see Exhibit 3). Players need to expand in both directions, going up the chain into asset management as well as further down into sales, distribution and marketing. These changes need to occur rapidly, and within the context of the most challenging economic and financial environment we have seen for decades.

Exhibit 4 sets out the strategic choices life and pensions players will need to make in response to the six trends impacting the industry.

The changes we have witnessed so far have come at a breathtaking speed. Anticipating and responding to the trends in the life and pension industry will allow insurers to control their own destiny and build a sustainable profitable future. Those who fail to do so might be those having to collect their own retirement funds soon.

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