Are You Ready?

by John J. Kollar, FCAS, MAAA

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This paper is dedicated to the memory of Philip D. Miller, who died in the World Trade Center tragedy on September 11, 2001. A Fellow of the Casualty Actuarial Society, Phil was a valued colleague and a friend. We miss him sorely.

Abstract

This paper presents a possible vision for the treatment of property/casualty and other related risks in a converging financial-services marketplace. While each market-generated development is not equally probable, substantial change is likely.

To succeed in the coming decades, actuaries — like their employers — will have to meet changing marketplace needs. The CAS brings value to its members and their clients by providing education and research that help members meet those changing needs.

The purpose of this paper is to encourage CAS members to develop their own visions of the future marketplace and to stimulate change in CAS research and education to meet the needs of the new and still-evolving financial-services marketplace.

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Personal Auto Product

Imagine a financial-services company of the future — call it Utopia Financial — that offers a personal auto insurance product in conjunction with other financial services. In addition to the traditional rating variables for auto insurance (age, sex, geography, vehicle, and so on), Utopia's program includes an option for a new-car loan at discounted interest rates. The size of the interest-rate discount increases with the length of the driver's claim-free period. The program is popular with clients because it rewards good driving experience with lower-priced auto loans — a tangible benefit of insurance coverage. Clients with several years of claim-free experience are not likely to relinquish this valuable benefit and move to another provider.

But that's only the beginning of Utopia's combined services. The company's large portfolio of clients and their purchasing power also give Utopia leverage in obtaining favorable new-car prices from selected auto dealers. That benefit adds to the company's value for its clients. And for the wealthier clients who do not need discounted auto loans, Utopia offers further discounted auto prices for drivers with several years of claim-free experience. Those special prices are another incentive that encourages the company's clients to continue as customers.

Homeowners Product

Utopia also offers a homeowners program. Using an integrated database on auto and homeowners, the company can sharpen its homeowners pricing. And as in the auto program, the company establishes a financing option — in this case, offering discounted rates for mortgages and home equity loans as long as the homeowner is a client. The company offers a claim-free discount for homeowners, as well.

Personal Financial Management Program (PFMP^{SM})

Tying the package together, the company offers a Personal Financial Management Program (PFMP^{SM}). The personal auto and homeowners products are integrated parts of this comprehensive program, which provides a broad range of financial services to Utopia's clients.

The company has client representatives responsible for developing each client's financial plan. The first step in the process is to identify financial objectives, including capital-development and short-term cash-flow needs. Capital development generally includes savings and investments for a home, career development, children's college tuition, premature death, retirement, estate planning, and the like. Utopia integrates and balances those long-term objectives with short-term needs to yield a realistic budget that meets the client's financial objectives. Company representatives regularly review the budget with the client and adjust it to meet the client's evolving needs.

Beginning with direct payroll deposit to the client's PFMP account, Utopia automatically pays the client's bills and sets aside funds for capital development. The automatic bill-payment service provides for an optimum mix of credit card and debit card purchases, another benefit of the company's purchasing power. Utopia makes debit card purchases when the company can obtain cash discounts for its clients from selected merchants. Recognizing that some clients will occasionally need short-term loans to cover extraordinary expenses, Utopia provides financing at favorable rates. Those loans are due in full when a client leaves the company's program. Many of Utopia's clients make provisions in their budgets for additional savings. By managing its clients' savings and capital development, the company virtually eliminates any client credit risk.

An employer's 401(k) savings plan is a natural starting point for capital development. Utopia establishes relationships with most of its clients' employers to manage those plans. Through the

PFMP, Utopia's client representatives keep up to date on their clients' evolving needs, so the company can work with employers to design savings programs attractive to the employees.

Utopia provides and advocates diversified investment options to meet clients' capital-development objectives, although clients have the option to select their own investment plans.

The familiarity of Utopia's client representatives with their clients' finances and financial objectives (and the relative financial homogeneity of its clients) also enables the company to provide expert income- and estate-tax advice at lower cost than independent tax advisors.

Information Management and Privacy

Because Utopia's PFMP provides comprehensive financial services, the company has access to virtually all of its clients' financial information. Except when adding new clients, the company has no need to obtain credit or other financial information from outside sources. In fact, Utopia carefully guards that information on behalf of its clients (and particularly for the benefit of its own customer-retention program).

Utopia's clients are comfortable with the company's handling of their financial information, because the company provides that information to outside organizations only if the client expressly directs it to do so. Upon request, Utopia develops a financial-strength rating for a client and sends it to a company or institution specified by the client. In exchange for that rating, Utopia requires the entity receiving the information to supply records of all of its financial transactions with the client. Those records contribute to the completeness of Utopia's financial information.

As Utopia's financial history on a particular client grows, the company can offer a variety of discounts and other benefits — particularly if the client's financial strength rating is favorable. Furthermore, Utopia's PFMP delivers substantial value and convenience to clients. Clients appreciate both the expert advice they receive at favorable prices and the time savings they realize from dealing with a single supplier for a wide range of services.

Pricing

Although Utopia's actuaries analyze the costs of the personal auto and homeowners products, first separately and then combined, the company actually integrates the pricing across the full breadth of services in the PFMP. Therefore, the company's multidisciplinary pricing team needs to include bankers and marketing people, as well as actuaries. The breadth and integrated nature of the PFMP make the cost analysis complex for the pricing team, but the pricing structure is transparent to Utopia's clients.

The comprehensive nature of the company's client database allows the PFMP pricing team to analyze costs by service as well as combined. The breadth of the services provides many opportunities to reduce risk through diversification. That reduction in risk reduces Utopia's overall cost of capital and yields substantial savings across the entire PFMP. The company can allocate the cost of capital to each service based upon its contribution to risk, after taking into account the benefits of diversification. In situations where Utopia has excessive concentration of risk, the company securitizes and sells its risk to the capital markets. Utopia always looks for ways to diversify its risk and minimize its (cost of) capital.

Client Retention

The comprehensiveness, integrated nature, and favorable pricing of Utopia's services keeps its client-retention rates very high. That excellent performance reduces marketing and sales costs, since the company does not need to replace many lost clients. The favorable client-retention rates also reduce hazard losses on the company's mature client portfolio.

Marketing

Utopia focuses on selected market segments, customizing the PFMP to meet the needs of those segments. The company began with a mix of clients from its previously existing banking and insurance businesses, but it has expanded to professional groups, unions, and affinity groups. As the company collects information on its clients and gains an ever better understanding of its target markets, Utopia can price its services ever more precisely.

Although Utopia prefers to provide the full range of services in the PFMP, some (generally wealthier) clients select only a subset of Utopia's services. Also, for some new clients, the company initially provides only selected services. As a client's account matures favorably, the company offers additional services.

The Making of a Financial-Services Company

Utopia Financial operates in the context of a financial-services industry that changed rapidly at the end of the twentieth century and in the first decade of the twenty-first century. Looking back at that period of change, we can see the forces that shaped Utopia's development.

The functions of insurers, banks, and securities firms have always overlapped. Insurers have always made investments; reinsurers have made loans; and so on. All branches of the financial-services industry have dealt with risk involving contingent cash flows.

In the 1990s, all parts of the financial-services industry began to converge even more. Banks purchased insurance companies and agencies and began selling insurance products. Insurers set up banks and began providing banking services. Congress recognized the trend and passed the Gramm-Leach-Bliley (GLB) Act of 1999.

The mergers and cross-selling of services were the first steps in the post-GLB convergence process, generating only minimum added value to customers. But many of the new entities — particularly the large, long-term providers — were steeped in their own traditional ways of providing their specialties, whether insurance or banking. The companies had developed customary ways of thinking about what their services were and how to provide them. Those traditions made it very difficult or even impossible for the companies to change and meet the needs of the evolving marketplace. Many of the companies were unsuccessful and have not survived as independent entities. They could not develop new, integrated products that would provide a more holistic treatment of risk and create added value for their customers.

Foreign financial-services companies did not suffer from pre-GLB traditions and were leaders in the integration of financial products in the United States. But some foreign companies brought their own cultural baggage and could not meet the needs of the U.S. marketplace.

Some domestic leaders in the U.S. financial-services industry were not long-term players in property/casualty insurance or banking. Utopia Financial, for example, was a new company, formed from the merger of a younger bank and property/casualty insurer.

Such companies, unrestricted by the traditions of the pre-GLB marketplace, could often identify needs and devise simple solutions that did not have to overcome internal traditional beliefs. Utopia's staff understood that customers wanted comprehensive solutions to their financial-management needs. Insurance and banking were merely tools to help the company meet those needs, rather than complete solutions.

Being a new player, Utopia was adept at using the improvements in technology that changed how business operates. For example, the Internet provided a market and a delivery mechanism for information. E-mail provided instantaneous worldwide communication at minimal cost. The growth in computer power and related technologies allowed for modeling of complex processes and nonlinear solutions.

Securitization of Risk

One of the key structural changes in the way companies like Utopia provided insurance coverage was securitization of property/casualty insurance risk. Before securitization, property/casualty insurers were always struggling with bad loss years and insurance pricing cycles, which contributed to their below-average and cyclical profitability.

As securitization instruments evolved, they gradually gained popularity with investors and insurers. Responding to growing marketplace pressure, regulators, in turn, accepted securitization instruments as an acceptable way of transferring insurance risk to the broader capital markets. That transfer of property/casualty risk allowed insurers to hold substantially less capital, thereby improving their profitability. Property/casualty insurers changed their primary function from risk takers to risk aggregators. The increased profitability of risk aggregation made such business desirable. And integrating property/casualty insurance with other financial services also became an increasingly attractive business proposition.

Property/casualty securitization began with (large) catastrophe exposures, specifically hurricanes and earthquakes. It then spread to standard lines of business.

Catastrophe bonds provided customized solutions for some insurers. Industry loss ratios provided simple coverage triggers for other catastrophe bonds, call option spreads, and other financial instruments. Industry data collectors provided industry indices as well as historical information to level the information playing field for investors.

The use of industry indices raised the issue of basis risk, the difference between an insurer's loss experience and the industry's. Reinsurers and other financial institutions filled the gap by providing a form of quota-share reinsurance to cover basis risk. Preferred reinsurance programs gave insurers more favorable pricing and terms. In exchange, the providers of those programs required insurers to meet specific standards on the policies they insured.

Mutual Insurers

In the early twenty-first century, mutual insurers were subject to the same marketplace demands that shaped the rest of the financial-services industry. Mutuals needed to provide comprehensive financial services to their clients, and that need pushed the companies to try new ways of operating.

Even before 2000, some such firms had demutualized to raise more capital, make insurer acquisitions, or provide stock and stock-option ownership incentives to staff. In the first decade of the twenty-first century, many more firms demutualized and merged with other financial-services companies to offer the expanded services that their clients demanded and their competitors already provided. Those that succeeded in offering more services benefited, not just from enhanced revenue, but also — thanks to diversification — from decreased volatility in earnings.

Many mutual insurers had been more interested in gaining market share than in providing an adequate return on capital (policyholders surplus). For such firms, demutualization and merger — and the accompanying new business focus — had the ancillary benefit of reducing their former strategy's downward pressure on profits.

Small Commercial Market

In the early twenty-first century, the market for small-business financial services evolved in a similar fashion to the personal-lines market. In addition to small-business package policies to cover property/casualty exposures, customers wanted comprehensive solutions to their financial needs. Successful financial-service providers focused on understanding and meeting the needs of specific market segments, rather than on providing limited services to a broader market. Such companies offered their clients new, integrated products that met their cash-flow and capital-management needs.

Enterprise Risk Management (ERM)

The market for large-business financial services began evolving much earlier than the personal and small commercial markets. By the 1990s, the world was shrinking, with more and more enterprises operating internationally. Property/casualty insurers had to provide international coverage to satisfy their clients' needs.

Large commercial banks assumed property/casualty risk through leasing and other arrangements with their clients. Reinsurers provided financial reinsurance to help primary insurers cover their financial needs. The differences between the products of reinsurers and commercial banks were more imagined than real, frequently more a matter of semantics than substance.

Large corporations and institutions sought alternatives to insurance, whose price and coverage provisions often varied substantially over an insurance cycle. For example, corporations and institutions worked with securities firms to package and sell various risks to the capital markets.

Many large companies and other organizations appointed chief risk officers (CROs) to identify, understand, and manage the risk they faced. Typically, the CRO of each entity conducted an analysis across the entire enterprise, integrating various risks to generate a comprehensive assessment of the entity's overall exposure. Furthermore, the CROs considered opportunities as well as risks in their enterprise risk management (ERM) assessments. Based on those integrated assessments, the CROs determined how to treat the risk — through retention, transfer, securitization, and other mechanisms.

Acquiring Skills

In the world where Utopia Financial operates, the old product orientation of the insurance and banking industries has evolved to a client focus for specific market segments in need of comprehensive financial services. Utopia provides its Personal Financial Management Program (PFMP) to carefully defined segments within the personal market. To serve those segments effectively and efficiently, Utopia needs to employ professionals with broad mix of skills and special expertise in many areas.

For example, the leader of Utopia's PFMP pricing team is an actuary. But because of the breadth of services in the PFMP, that actuary has to be able to coordinate the efforts of a wide variety of subject-matter experts.

The team leader's initial training as an FCAS focused on treatment of property/casualty risks. But that training also provided a good understanding of finance. And CAS continuing education gave the leader an understanding of financial products and the work they require. The continuing education, based on research done by CAS members, also included seminars and other educational tools developed with financial experts from a variety of disciplines.

Today, successful actuaries must expand their knowledge and experience beyond the traditional areas of activity for an FCAS. Utopia Financial recognizes the subject-matter expertise of its actuaries — as well as their leadership, communications, and teamwork skills. That blend of expertise and skills serves the company and its actuaries well in the marketplace of the twenty-first century.

Closing Comments

The convergence of the financial-services industries is likely to have a dramatic effect on the treatment of property/casualty risk. As we live through such developments over the next ten or twenty years, we will probably view the changes as evolutionary. But historians with the benefit of hindsight might characterize them as revolutionary.

Evolutionary changes provide time to adjust, but the gradual nature of such changes can mask their magnitude. Today's CAS education will generate tomorrow's actuaries. Therefore, our current educational programs must anticipate the changing needs of the marketplace.

This paper presents a possible vision for the treatment of property/casualty and other related risk in a converging financial-services marketplace. Each market-generated development is not equally probable. But change is certain.

To succeed in the coming decades, actuaries — like their employers — will have to meet changing marketplace needs. The CAS brings value to its members and their clients by providing education and research that help members meet those changing needs.

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