

Insurance and financial services review

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 **Watson Wyatt**
Worldwide

Which way now for with-profits?

Richard Waller looks at the recent proposals for with-profits business and considers the likely consequences.

Since the FSA launched its wide-ranging review of with-profits business in February 2001, there have been one open meeting, five issues papers, and two feedback statements to digest. At the same time, Ron Sandler has been reviewing medium- and long-term retail savings, including with-profits business, on behalf of HM Treasury, and there has been plenty of press comment to bring all of this to the attention of the consumer. So where does all of this leave with-profits business?

It seems that there will still be a place for with-profits business in the range of savings opportunities available to consumers, but not necessarily in its current form. Following its review, the FSA has put forward some proposals designed to reform with-profits business and improve consumer confidence in it. Further consultation on these proposals will take place during the next 12-18 months, and is likely to feature Sandler's complementary recommendations, including his new with-profits model. However,

we are still at the stage of proposals and recommendations, not new rules with fixed implementation dates.

Nevertheless, given the groundswell of public opinion that has built up in conjunction with frequent lobbying from consumer groups, it seems inevitable that the FSA's proposals, influenced by Sandler's recommendations, will become rules in some form. Life insurers would therefore be wise to start preparing for the changes now.

Fund structure

Fund structures that fail to provide the required transparency in respect of charges and financial management are almost certain to be casualties of the reform, at least for new business. The vast majority of new with-profits business currently transacted is on a unitised basis, and a significant proportion has 100% policyholder participation in investment profits only. However, these structures typically lack transparency and hence may need further alteration, particularly to conform to Sandler's with-profits model. A number of insurers have already moved in this direction in anticipation of the reform. Even so, material amounts of business are still written on a 90:10 basis; large amounts are also written by the remaining mutuals, with

participation in other profits and losses.

Under the model put forward by Sandler, there are three separate accounts: a policyholder investment account, a smoothing account and a supporting capital account. Explicit transfers are made between them to reflect smoothing and the cost of capital support. In addition, management services will be provided outside the with-profits fund (by a separate company if Sandler's model is followed fully), and paid for by explicit charges to the investment account. The FSA will probably want some control over the charges levied against the



Richard Waller

Richard Waller is a senior consultant in Watson Wyatt's Financial Management team.

policyholder investment account to fit in with the lighter regulatory regime envisaged by Sandler, so from a consumer's perspective the

with-profits fund may become a smoothed investment fund supported by regulatory pressure on charges.

What this currently means for existing with-profits models - including the traditional 90:10 model - is unclear, although it will be difficult to legislate them out of existence. It may be that the Sandler model comes in for new 'stakeholder' with-profits (see below), but that other structures can be used for 'non-stakeholder' business provided they meet the necessary transparency and disclosure requirements.

If the Sandler model is implemented in some form, it will be necessary to determine the supporting capital to be made available; this will require complex asset-liability modelling of the new with-profits fund. This modelling will need to allow for, amongst other things, the intended underlying asset mix, the smoothing method, and expected new business volumes. Alternatively, the modelling could be done to determine the appropriate smoothing method given the supporting capital available. Experience shows that, if fair treatment for all policyholder generations is to be achieved, mechanisms may need to be in place to help decide when one with-profits fund should be closed to new entrants and a new fund started. Whatever the outcome, it will be important to do this work in



a robust and thorough manner at the outset, as the ability to change smoothing and charging methods over time is likely to be constrained by greater disclosure.

Governance

This reform may lead to the closure of some with-profits funds, which will then need more monitoring during run-off to ensure fair treatment for all concerned. Setting up a monitoring process may be a burden initially, but should entail relatively low maintenance and will

in any case be a necessary part of the company's capital management process. If the Sandler model is implemented, ongoing monitoring of the interaction between the capital support available, the smoothing method and the fund size will also be necessary to avoid unpleasant surprises, and to ensure the efficient use of capital in any new with-profits fund.

The FSA has also floated the idea of a With-Profits Fund Committee with responsibility for ensuring that policyholders' interests are taken

into account. If Sandler's recommendations are followed, the role of such a committee would probably be limited to monitoring the existing, non-transparent, with-profits funds. Even so, the FSA's proposals for the governance of with-profits funds, added to the

simplify taxation measures, but would be consistent with the Chancellor's previous approach.

As with the pensions equivalent, the proposed 1% annual charge cap for such products is likely to impinge on profit margins and increase the importance of

the increasing competition and pressure on margins within the protection market, may be a timely opportunity for some companies to broaden out and spread their costs.

As noted above, Sandler has recommended a simplification of the taxation treatment of insurance business, which may bring it more into line with, and hence more directly into competition with, other savings vehicles. In addition, if insurance savings loses its 5% tax-free withdrawal status, the with-profit bond could lose some of its appeal; new product initiatives might be necessary to attract similar savings via insurance in the future.

“...we may see a two tier market developing for with-profits savings in the same way as has happened with personal pensions.”

senior management systems of control regime introduced at N2, will make company directors more accountable for the operation of these funds. The need for external input and advice to demonstrate that policyholders are being treated fairly may therefore become greater.

Products

The FSA's review did not touch on product details, but Sandler's recommendation of a 'stakeholder' with-profits product is likely to find much favour in a Government keen to promote cheap and accessible savings for all. However, given the FSA's reluctance to regulate products, it is difficult to see how HM Treasury can push through the introduction of such policies. One possibility is through favourable tax treatment, which would be contrary to Sandler's recommendations to

customer servicing and product persistency. It may also lead to a reduction in the guarantees offered, as the cost of providing guarantees will have to come from within the charge cap. However, the 'non-stakeholder' route will remain open for companies wanting to impose higher charges and provide more complex benefits, and so we may see a two-tier market developing for with-profits savings in the same way as has happened with personal pensions.

Sandler's recommendations include the removal of a significant part of the Conduct of Business Sourcebook requirement for 'stakeholder' products, and the removal of commission payments for independent sales. These measures could tempt more insurers back into what was the 'regulated sales' savings market and, in view of

Disclosure

From the perspective of both regulatory supervision and consumer information disclosure on with-profits is going to change, and will almost certainly increase. The FSA seems set to introduce some form of standardised realistic reporting requirement for all with-profits funds, possibly based on asset shares. How this approach will fit with fair value reporting is currently unclear, but it seems misleading to introduce spurious differences in reporting realistic liabilities for these two purposes. It is also likely that some publicity surrounding the principles and practices governing the management of with-profits funds, and an annual report providing details of each fund's solvency condition, will be necessary.

Policyholders can expect to receive streamlined Key Features documents in future and an annual statement of their policy value on various different bases, quantifying the effect of smoothing. All new with-profits product literature will need an overhaul, as terms such as ‘asset share’, ‘bonus’ and ‘market value reduction’ are considered too complicated and in need of replacement by simpler terms. Many insurers have already made moves in this direction under the Raising Standards Scheme, but further changes may be necessary. It is debatable whether these moves will aid consumer understanding or just add another layer of complexity to an already confusing language.

Inherited estates

Without a ready source of available capital, particularly given current equity values, insurers may want to resolve the ownership of any inherited estate. Such a move would be welcomed by many, including the Consumers Association and Sandler.

It may therefore be appropriate for life insurers to quantify the effect of attributing the inherited estate, and to identify what capital is available to finance new initiatives. However, assistance from the FSA will not be coming soon; the FSA has pushed this issue to the end of the forthcoming consultation period, and is unlikely to be particularly co-operative while the consultation is outstanding. Furthermore, if the

Sandler with-profits model is implemented before inherited estate ownership can be resolved, it may be necessary to seek an additional source of capital to support new funds, or to delay the launch of new with-profits business.

An alternative to resolution of inherited estate ownership would be to convert the old with-profits fund to a new style fund with the required transparency in respect of charging and smoothing. Such a conversion may be costly and difficult to achieve in practice and hence is unlikely to be mandatory, although it has some appeal. For example, it could prevent an insurer from having to maintain separate

Sandler’s recommended introduction of ‘stakeholder’ with-profits business could trigger a fresh wave of consolidation in the industry as margins are squeezed further, but it also provides a way back in to with-profits savings for those companies previously forced out by the burden of sales regulation and compliance.

Furthermore, despite all of the recent publicity surrounding with-profits business, it is questionable whether the average consumer will be any better placed to understand it; consumers will still be dependent on advisers and insurers for fair treatment should they want a with-profits

“It is questionable whether the average consumer will be any better placed to understand it.”

with-profits funds, potentially avoiding a more burdensome governance arrangement.

Conclusion

It is interesting to note that, at a time when many of the developing insurance markets around the world are becoming open to new initiatives, the UK Government is keen on replacing the ‘freedom with publicity’ regime with heavy prescription over product terms.

investment.

Whatever the merits, change is coming and, even if we cannot be sure of what will happen, with this change will come opportunity. ■

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How critical is critical illness?

Sue Elliott discusses recent experience and trends in the critical illness market.

Critical illness (CI) is the fastest growing healthcare product line in the UK. Its appeal has derived from a combination of simplicity, the 'windfall' nature of the benefit, and its perception as a necessary protection product.

From 1991 to 1999 the CI market experienced remarkable growth of 20% per annum, (see Figure 1). There was a slight decrease from 1999 to 2000, which could be attributed to the reduced dependency on mortgage-related sales; however, the market rebounded in 2001 with a 12% increase.

The product is currently profitable, but there are concerns regarding the robustness of definitions against legal challenges as consumers become more aware of their rights, and concerns about the impact of medical advances given that the claims trigger is based on diagnosis.

Insured experience

The most recent published experience is contained in 'A Critical Review', presented at the Staple Inn, on 14 March 2000. It contains experience for 1991-97 inclusive (the 1998 and 1999 results are due

to be presented at the Institute and Faculty Healthcare Conference at the end of September).

The 'accelerated' experience appears to be stabilising (up to 1997) as the business begins to mature; however, firm conclusions cannot be drawn at this time, as the experience is five years old. The 1998 and 1999 results should provide more evidence of any developing trends.

Figure 2 summarises the experience for accelerated male non-smokers for a subgroup of companies that contributed data throughout the study.

The 'stand alone' experience, however, is showing signs of deterioration, which could be the result of anti-selection, given that there is no mortality benefit.

ABI Critical Illness Statement of Best Practice

The ABI developed a Statement of Best Practice for Critical Illness in April 1999. The aims of the code are to ensure that cover remains affordable and that cover continues to meet customer needs. The model wordings, which form part of the code, are set at an 'appropriate minimum standard'.

The code contains provisions for a review every three years. The first review has just been completed, and the Code and other relevant documents have been updated

with effect from May 2002. The review included consultations on the definitions of cancer and heart attack.

The revised cancer definition excludes less severe prostate cancer, reflecting a concern that the Government's Prostate Cancer Management Programme could lead to a dramatic increase in the number of detected cases.

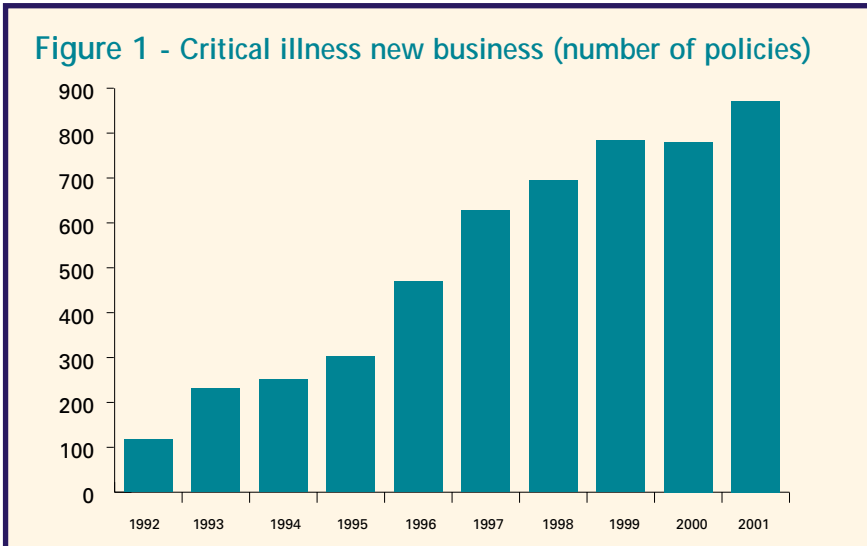
The revised heart attack definition makes reference to troponins to detect heart attacks. Given that the use of troponins increases the sensitivity of the test, there will probably be an increase in heart attack claims submitted.



Sue Elliott

Sue Elliott has recently joined Watson Wyatt's healthcare team and specialises in critical illness, income protection and long-term care.

However, insurance companies generally use stricter criteria in deciding on heart attacks than does the medical profession, and so



Source: Swiss Re Life and Health Watch 5

many of these claims might not satisfy the policy definition. We could see more declined claims, more ex-gratia payments, or possibly an increase in legitimate claim payments. More declined claims may cause problems with the OFT, while increased payments would need to be allowed for in pricing.

The multiple sclerosis (MS) definition has not been reviewed; however, there is concern of an accelerated diagnosis, leading to an increase in the incidence of claims as a result of the advent of MRI scans and the use of beta interferon. On the positive side, the underwriting techniques for MS are improving through more effective questions.

It is important to note that, normally, insurers cannot amend the definitions of CI for policies that are already in force; in other words, definitions are guaranteed.

Long-term rate guarantees

Reducing capacity in the reinsurance market for long-term guaranteed CI has highlighted many issues for this segment of the market, a segment that has historically been heavily reinsured. Similar concerns apply to reviewable business, because of the practical constraints on reviewability (in particular, PRE and commercial pressures).

When assessing the guarantee risk the following must be considered:

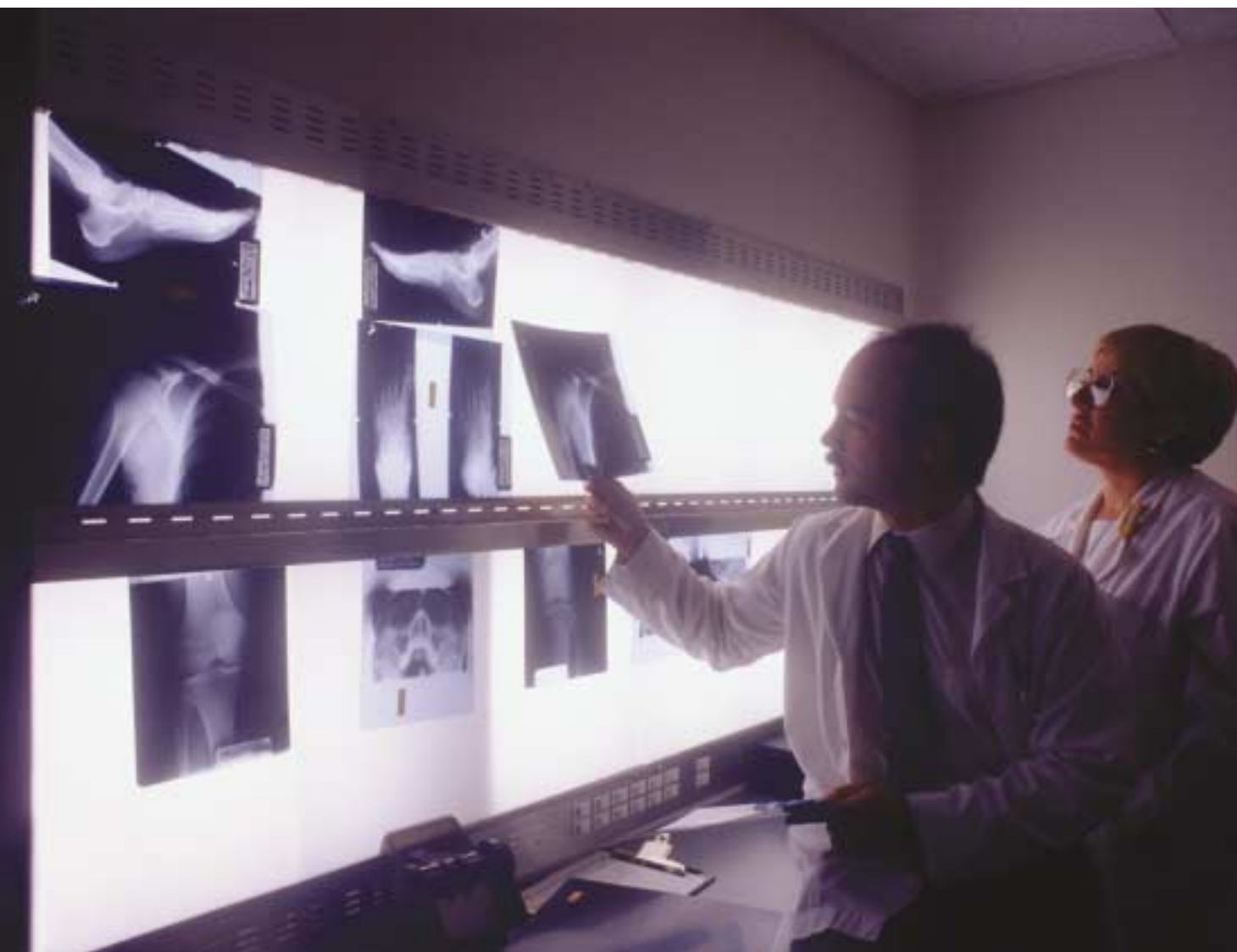
- credibility of data
- appropriateness of data
- effect of trends
- effect of shocks.

The last point is particularly significant when assessing risks on CI business, but it can be subject to wide interpretation. A common approach is to increase the loading for longer outstanding guarantee periods. The Society of Actuaries in Ireland has suggested the following, based on their research:

- loading = $x\%$ plus $y\%$ per annum
- where x is a flat margin, and can range from 35 to 50
- where y is an additional allowance for future trends, and can range from 1 to 3.

Table 2 - Accelerated male non-smokers; E = CIBT93

Year	A/E - all	A/E - subset
1991	70%	70%
1992	57%	57%
1993	48%	46%
1994	47%	52%
1995	40%	44%
1996	36%	47%
1997	43%	50%
1991 - 1997	43%	50%



Are the current guarantee loadings sufficient? If not, of course, companies will be faced with the problem that more appropriate loadings may make the coverage unaffordable.

Conclusion

What does the future hold for critical illness? Can it remain a

financially viable product in its current form?

Only time will bring us answers to these questions, but measures can be put in place now to minimise the financial risks associated with the product (in particular, robust monitoring of claims experience and medical advances). It is also important that mechanisms are put

in place that allow the product design (including the definitions), and the associated premium ratings, to change as new developments occur in the field of medicine. ■

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Reinsurance: a costly decision?

Justin Skinner considers approaches to choosing excess of loss reinsurance retention levels.

During the past year, particularly after the terrorist attacks of September 11, the cost of excess of loss reinsurance has increased dramatically while the tightening of policy wording has resulted in a reduction in cover. It might therefore seem necessary for insurers to increase their retention levels to avoid an increase in the cost of their reinsurance arrangements, but any cost benefits from increased retention must be weighed up against the increased risk retained. How best can the amount of reinsurance to purchase be determined?

Possible approaches

One approach is a global risk management exercise, encompassing all possible risks to which the company is exposed. Taken to the extreme, this approach would involve a sophisticated dynamic financial model of the company's business which would quantify the effect of large claims and hence, given appropriate risk criteria, help determine the reinsurance requirements. A simpler method involves an explicit model of large

claims, both gross and net of reinsurance. By adding the premium for a reinsurance programme to the net claims cost, the expected cost due to large claims can be assessed, along with its volatility. The large claims model would normally assess the frequency and amounts of large claims separately.

Claim frequency

If the insurer has a large portfolio, the number of large claims that occur in the following year can be predicted relatively accurately. Obviously, changes in the underlying exposure and claim frequency inflation would need to be allowed for where significant. For example, in the UK the numbers of large motor claims (after allowance for increases in exposure) have been increasing at, broadly, 6% per annum. Where less information is available, centralised sources may be required to give a market or peer-group comparison of the large claims frequency, which can be used as a basis for projecting the claim frequency. This claim frequency could then be used directly in a Poisson model, although the restriction that the variance is equal to the mean may lead to other models, such as the negative binomial model, being used instead. An example of a

distribution of the number of large claims is shown in Figure 1.

Claim amounts

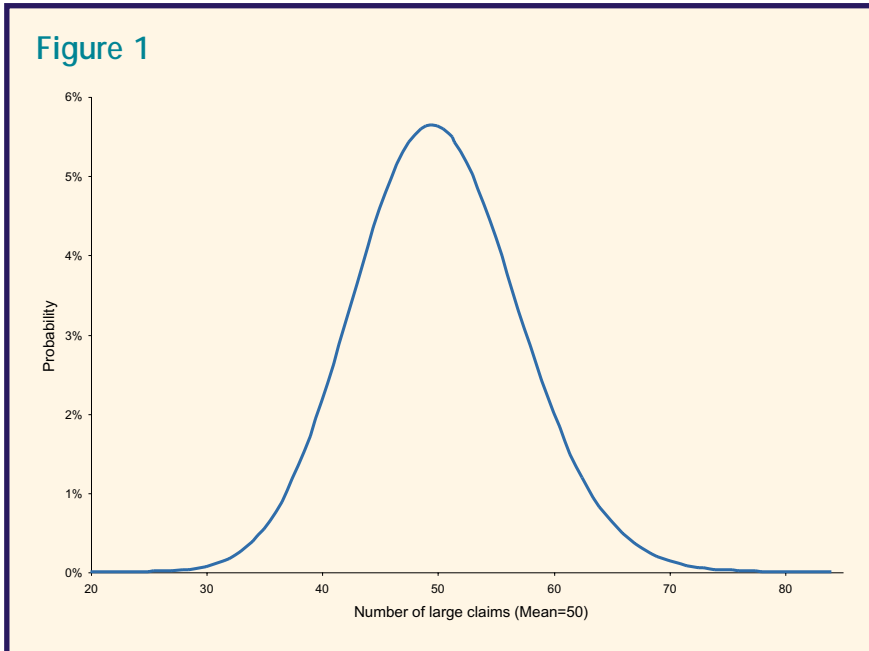
If there are a sufficient number of large claims, it is a straightforward exercise to fit a curve to the large claim amounts, allowing for claim size inflation (historically around 8% per annum for UK motor large claims) and for development in the incurred claim amount. In our experience with motor insurance, a curve can often be fitted remarkably well. For more volatile classes, or where there is less data, more approximate techniques or market/aggregated statistics may



Justin Skinner

Justin Skinner is a recently qualified actuary in our General Insurance team and specialises in stochastic modelling.

have to be used. For classes with a line structure, such as Professional Indemnity insurance, alternative (and invariably more complicated)



selected reinsurance programme to obtain the net cost of large claims during the following year. Assuming that the models are correctly parameterised, the true cost of reinsurance will be:

- the mean difference between the gross and net cost of large claims
- plus an allowance for expenses and profit
- less an allowance for the investment income on the reinsurance premium.

approaches need to be used; for instance, modelling the change in incurred claims as a percentage of outstanding claims, and applying this to a separate model of the initial incurred amount of a claim. For example, we might fit a Pareto distribution to the data, as shown in Figure 2. This distribution is fairly typical of large motor liability claims for a large insurance company.

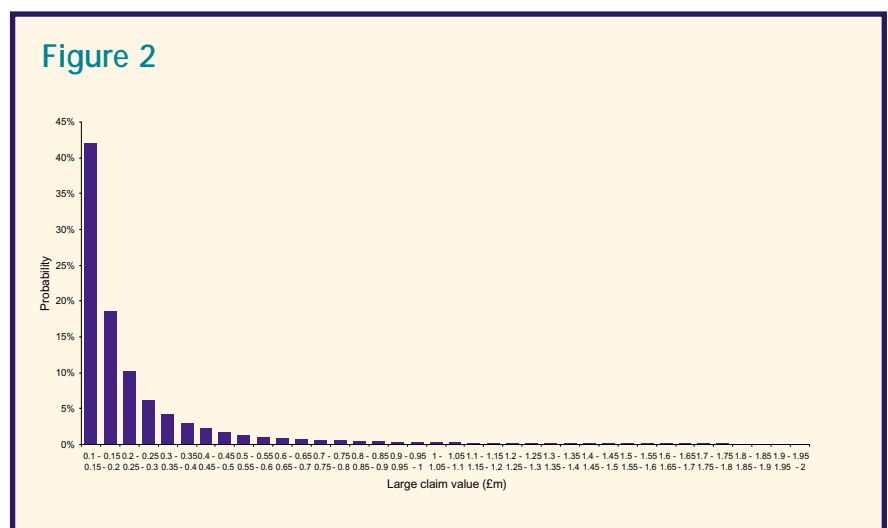
“In our experience with motor insurance, a curve can often be fitted remarkably well.”

Histograms of the net cost of claims plus the reinsurance premium can be used to compare different programmes in terms of their average cost, and the relative variations in their results.

For example, consider a decision between a £1 million or £5 million retention on a UK motor account. Choosing the £5m retention leads to a lower expected cost (with the

Putting it all together

Once the claim frequency and amount models have been determined, they need to be combined using a stochastic model. The number of claims is sampled from the numbers distribution, and then a corresponding number of claim sizes are sampled from the amounts distribution. These claims are then put through the

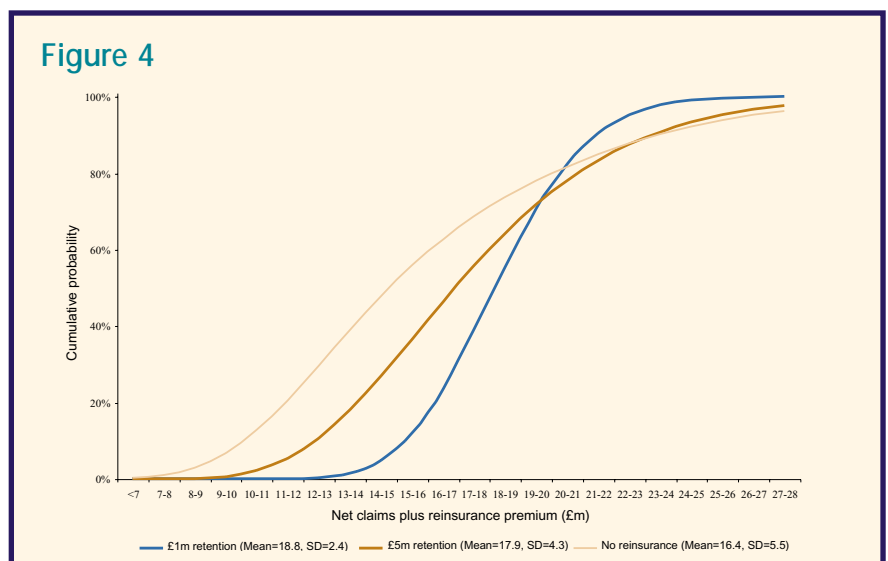
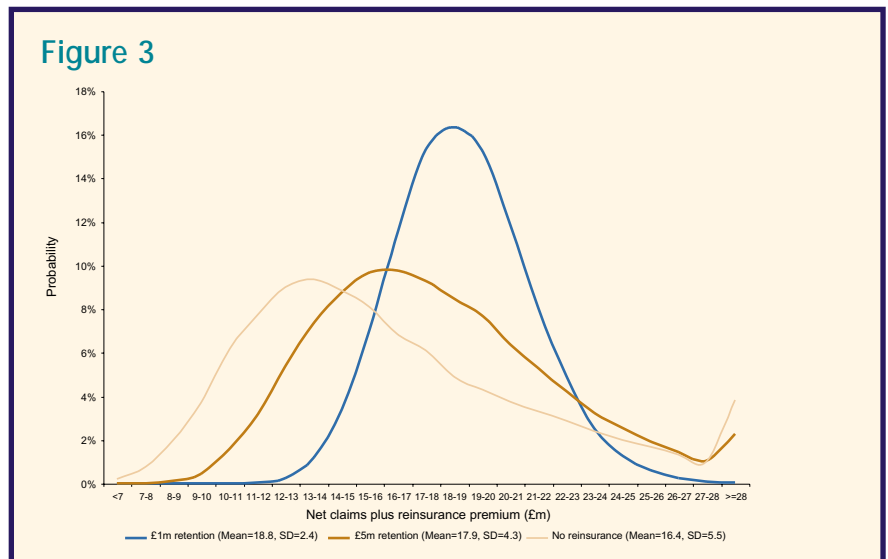


high retention programme giving a lower cost in 66% of the scenarios), but with greater variability and therefore increased risk. Moving to a strategy with an even higher retention exaggerates this effect, the extreme example being the simulated total gross claims (where the cost of not reinsuring the large claims is lower than the £5m retention programme in 86% of the scenarios). These effects are shown in Figures 3 and 4.

Summary

Deciding on the right amount of reinsurance protection has always been important, but, given the increased cost of reinsurance, it has become even more so. Ultimately, the decision reduces to balancing the risk of large losses against the higher expected cost of holding more reinsurance. Stochastic models of large claims can help in making this decision if they are correctly calibrated, but correct calibration depends on the quantity of large claims data. This is particularly true for very high retentions, where models calibrated to one or two large claims are of little use. In such cases, it is vital to use other market data in the decision-making process. ■

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Insuring the uninsured

Ian Shires examines the effects of financial exclusion on the take-up of home contents insurance, and looks at a recent project aimed at selling to the financially excluded.

The Government has become increasingly interested in the issue of members of the UK population who do not have any insurance or other basic financial contracts. The Social Exclusion Unit has been set up to address some of the key problems arising from financial exclusion, including how to widen the availability of insurance services, and the role of banks and other financial institutions in the delivery of financial services. A recent study has shown that almost 10% of adults do not have a bank account and over 30% of households have no savings or investment products. In addition, approximately 20% of households have no home contents insurance.

Customer concerns

The majority of households that do not take out contents insurance do not do so out of choice, and are often unemployed or on low

income and living in deprived areas. Approximately half of those who are uninsured have held a policy at some point but have let it lapse owing to financial difficulty. Often it appears that people have no insurance because no suitable products are available. This may be because of:

- the minimum sum insured being too high, resulting in premiums that are disproportionate to the risk
- the lack of any household member with a bank account from which to pay the premiums.

In addition, insurance might not be taken out because:

- the premiums are unaffordable, possibly because the house is in a high-risk area
- the premiums are affordable but the householder perceives the premiums to be high compared with the risks involved.

It is only in relatively few cases that the householder is unaware of the risks to which he or she is exposed, or lacks financial awareness. This is sometimes the case with Housing Association tenants, who may believe that their Local

Authority is responsible for contents insurance. To remedy this, some Local Authorities offer insurance themselves, with premiums collected weekly at the same time as the rent, thus making the insurance appear relatively affordable.

Insurer concerns

Clearly, the existence of a suitable insurance product coupled with an effective marketing campaign could be used to tackle some of the problems raised above. So why have insurance companies been reluctant to take these steps?



Ian Shires

Ian Shires is a consultant in our General Insurance team.

One obvious reason is the expense associated with selling policies with a small sum insured. The lower the sum insured, the

larger the proportion of premium that is required to cover fixed expenses, and hence the less attractive the policy appears. As a

we believe that the Insurance and Financial Services industry could generate profit-making business from this population group.

comprehensive ‘contents extra’ cover. The policy’s minimum sum insured is much lower than in RSA’s standard home contents cover to ensure that policyholders pay only for what they need, thus keeping premiums affordable. The Post Office provides a good way of selling to the financially excluded, as post offices are used more by this group than are other financial institutions. Since launching this product in March, RSA has underwritten 3,500 new policies.

“Often it appears that people have no insurance because no suitable products are available.”

result, insurers often set a relatively high minimum sum insured, which also helps with the problems associated with under-insurance. Often, policyholders do not realise that this sum insured needs to allow for the cost of replacing items ‘as new’. For individuals with no bank account, premium collection becomes expensive or impossible.

Another reason why the take-up of standard products is relatively low in high-risk areas of the country is that risk premiums are often a substantial percentage of the sum insured. Premiums may be particularly high under policies offering ‘new-for-old’ cover where there may be greater instances of fraudulent claims in deprived areas.

Making it work

Designing products to sell to the financially excluded is often perceived as a bad risk but, with the proper research and marketing,

Royal & Sun Alliance (RSA) have recently launched such a product through the Post Office using a television advertising campaign and leaflets displayed in branches. The aim is to attract people in the following categories:

- people in lower income bands
- people without bank accounts
- old age pensioners.

The product offers a flexible home contents policy with up to five options for the sum insured. It also gives the option of paying the premium by cash over-the-counter at the Post Office, in addition to the more traditional methods. The leaflet is quite detailed, explaining in clear and simple language the options available and how to calculate the premium. The product is two-tiered, offering either a standard contents cover or a more

The way forward

This is an interesting illustration of combining underwriting and marketing skills around a well-defined customer/distribution segment. How often does the insurance industry think like this - and is there scope for more creative thinking? ■

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Affinity marketing: the latest developments

Frank Fletcher looks at the evidence of Watson Wyatt's most recent affinity marketing survey, and wonders if non-traditional distributors are losing credibility with their partners.

The year 2001 may prove to have been something of a watershed in the topography of the distribution partnerships landscape. Before last year, there was a clear view among both distributors and financial services providers that partnerships represented an attractive and low cost route to market for a range of financial services products. The brand would do the marketing; the provider would benefit from the competitive advantage of larger scale manufacturing.

Experience is bringing this theory into question, however, and there is some evidence that financial services providers are retreating to the comfort zone of preferring to deal with other financial services providers and distributors. According to analysis in 'Affinity - the next generation', published by Watson Wyatt in March 2002, the issue does not lie

especially with distributors - who, on balance, report that they perceive the partnerships in which they are involved reasonably positively - but with the providers. They report a more variable experience, and partnerships that are regarded as successful are outnumbered at least 2:1 by those that are considered disappointing.

As a result of their experience, many providers are focusing on the bigger opportunities and, in their experience, such opportunities are associated mostly with other financial institutions. The evidence of this year's survey is that providers are planning to reinforce their focus away from smaller groups with more specialist needs and niche markets. This adjusted focus may also be a reflection of the commonly held view that no one can 'do' financial services as well as a financial services company can.

Future experience may, or may not, prove this view to be valid. Meanwhile, what might be causing this disillusionment with non-traditional distribution opportunities? After all, at a time when providers' margins are under pressure from all sides, there is a need to maximise distribution reach, and to minimise the unit cost of business acquisition. On paper, partnerships offer one attractive solution.

Alongside the main questionnaire for this year's partnerships report, Watson Wyatt also conducted a series of senior executive interviews with a number of 'best practice' participants in the partnerships market. Detailed results remain confidential to the survey respondents, but it is possible to highlight some of the principal conclusions relating to success factors in partnerships. These conclusions can be applied by all companies to their own partnerships operations to identify areas for improvement.



Frank Fletcher

Frank Fletcher works in our strategy team, and specialises in affinity marketing.

What goes wrong in partnerships?

A common cause for complaint among providers is the quality of

data available from distributors. Partner commitment can be a serious problem for provider companies; one in three providers report that they do not feel that their distribution partners are taking the partnership sufficiently seriously. This factor alone would be

distributors is being increasingly fuelled by factors like:

- growing product simplicity and transparency
- the introduction of stakeholder pensions

“One in three providers report that they do not feel that their distribution partners are taking the partnership sufficiently seriously.”

enough to push some providers back to the relative safety of other financial institutions, whose very lifeblood is the revenue they generate by addressing the financial needs of their clients.

Apathy, lack of focus, flexibility, cultural misalignment, slow speed of decision making, communications failures, and lack of experience on the part of distributors: all of these contribute to providers' disillusionment with the business.

In addition, some providers also expressed concern about IT systems costs and implementation, distributor sales process implementation, and regulatory and compliance issues.

This is especially bad news given that survey respondents feel there is substantial unfulfilled demand in the market which non-traditional partnerships may help to address. The potential for non-traditional

possible changes in point of sale regulation of financial services

the increasing awareness of the consumer of the need to protect him or herself as well as dependants as state support is withdrawn

the dangers of possible financial disenfranchisement of the less well off by the increasing cost of providing advice or guidance.

There is a perception among this year's survey respondents that partnerships can play an increasingly important role in the distribution of life, health and pensions products in the future, alongside the already well established partnership markets for household, motor, creditor, travel and other forms of general insurance.

Recipes for successful partnerships

Although the background is positive, it is important to avoid the aspects of negative experience reported in this year's survey. When asked about specific areas of concern for the future, distributors did not indicate any particular burning issues. By contrast, providers showed concerns about:

- lack of control of the distribution process
- poor or inadequate management information coming from distributors (whereas distributors themselves had expressed satisfaction with the management information they were receiving)
- inadequate scale of business being delivered
- possible reactions of traditional distributors to involvement in this market
- competition (from other providers and from other distributors)
- reputation of the distributor partner.

Our analysis of successful partnership management suggests that non-traditional distributors can break into the magic circle of good practice by adhering to the following rules in identifying and dealing with their provider partners:



- partnerships between organisations of similar size work well
- understanding partners' motivations and objectives is essential
- demonstrable commitment to joint working is necessary
- compact partnership teams seem preferable
- short decision-making lines and processes are most effective
- good practice requires board level commitment and involvement
- close team working and joint problem solving is an essential element of success
- clear understanding of respective roles and responsibilities is critical to success
- challenging but achievable milestones agreed between partners work well.

There are many instances of successful partnership working in the UK, so it can be done. Following these simple rules may well allow non-traditional distributors to restore their credibility with providers at the same time as helping their own clients to address their financial services needs. ■

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Russia: if you want to eat fish, get into the water

Russell Beaumont looks in detail at the Russian insurance market and its attractions.

The Russian market may have some obvious attractions for Western insurers:

- a population of over 150 million people
- an apparent economic recovery following the financial crisis of 1998
- a degree of political stability and improving diplomatic relations
- a low penetration of retail insurance products.

There are also three big fish on the horizon, providing mouth-watering opportunities:

- compulsory motor third-party liability (MTPL) insurance
- the development of a life insurance and savings market
- pensions reform.

Current market

The large insurance companies benefit from providing two products that would not be familiar

to many insurers. Compulsory medical insurance, which requires the provider to transfer money from the mandatory medical fund to healthcare institutions in return for commission, and the notorious 'payroll' scheme in which an insurer acts as a tax efficient vehicle for transferring money from employer to employee. In both cases little risk is borne by the insurer.

Other successful insurers are captives of the large industrial corporations, existing primarily to provide property insurance to their parent companies. However, their owners can see the business opportunities and are directing their subsidiaries to expand their product range and compete on the open market.

Compulsory motor liability cover

Russia is one of the last countries in Europe to require MTPL cover.

The law was passed in May 2002, and will come into effect from July 2003.

Although the law sets out the limits of liability, the premium rates have not yet been determined. We estimate that the potential size of the market could be premiums of more than USD 1 billion.

Experience in other Central European markets suggests that some insurers that achieve a growing market share do not set up adequate reserves. The supervisors

will need to pay special attention to the reserving practices of Russian companies to avoid potential insolvencies damaging the fragile reputation of the insurance market, particularly as:

- Russia has one of the highest motor fatality records in the region, and the CEE region is among the worst in the world
- settlement procedures for claims are also likely to be less than clear
- there are still many small insurers in Russia.



Russell Beaumont

Russell Beaumont works in our strategy team and specialises in Central and Eastern Europe.

Life and savings market

The statistics for the Russian life insurance market give a misleading picture. It has been estimated that over 90% of life



business comes from payroll schemes. However, proposed amendments to the tax laws could all but eliminate this type of business.

The remaining life business that stays onshore is sold in Moscow and St. Petersburg. Russian wealth is concentrated in a few hands and in a few cities. Experience in other emerging economies suggests that, as this wealth starts to filter through to the middle classes, a dramatic growth in premiums may be triggered. In addition, a stable environment allows people to plan their finances, and continuing economic recovery allows more

There are already more than 260 private pension funds in place. The largest of these Non-Government Pension Funds (NGFs) are in the same industrial groups as the big insurance companies. Although it is thought that, from 2004, NGFs will compete to manage the assets of the funded pillar, their precise role in relation to the State Pension Fund is still being decided.

Even more uncertain is the role of insurance companies. It has been suggested that insurers wishing to take part in the reforms should either set up NGFs or wait until they can provide annuities to

“Russian wealth is concentrated in a few hands and in a few cities.”

people to consider the luxury of life assurance.

Pension reforms

The Russian Federation is in the process of reforming its pension system. The political process seems complicated to an outside observer. However, from the beginning of 2002 the legislation has been in place to begin diverting 14% of salary towards a mandatory funded pension system.

pensioners. What is clear is that in all other Central and Eastern European countries, and no matter what the style of the reform, successful insurers have always found a way to be at the forefront of provision. We expect it will be no different in Russia.

Getting into the water

So if the potential is big, and the timing is right, why are so few Western insurers currently fishing?

There are restrictions on the way that foreign insurance companies can operate in Russia. There is a limit of 15% of authorised capital that can be controlled by foreign companies, although overseas investors have, to date, used only around 4% of their allocation.

Foreign owned insurers are also restricted from providing compulsory medical insurance and life insurance. This restriction prevents them from operating in about two-thirds of the total market.

Companies are finding ways of overcoming these restrictions. However, even putting aside the issues of control, an entry plan for the Russian market will need to convince the board that other operating risks are manageable. For example, how can an overseas company enter and operate

effectively in the country's less-than-transparent business environment? Is long-term economic recovery realistic, or is it being sustained by subsidies to industrial producers, with another crisis potentially just around the corner?

One of the major stumbling blocks to Russian entry into the World Trade Organisation is the restriction on foreign insurers from competing in the life assurance market. The latest rumours are that Russian resistance could soften, possibly in exchange for tax concessions to help domestic insurers survive. If this restriction is lifted then, as the Russians say, you need to be in the water to catch the fish. ■

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The Appointed Actuary system in Belgium

Karel Goossens and Jan De Roeck explain the role of the Appointed Actuary in Belgium.

Background

The role of an Appointed Actuary (AA) in Belgian Legislation was first introduced in 1975, but was not put into practice until 1994. In 1995, the Belgian Insurance Control Authorities (CDV-OCA) tried to clarify the role of the AA; after due consultation, the CDV-OCA detailed, in its communication D206 of 9 November 2001, the role of the AA for both life and non-life insurance activities.

The criteria to which an AA should adhere are in the Royal Decree of 22 November 1994.

In this Decree we find that the AA cannot belong to the management committee of the insurance company being advised. This means that, if the AA is internal to the company, there may be some constraint on their role within the company. In practice, there are similar numbers of internal and external AAs.

Field of application

What is to be expected of the AA?

The role of the AA is not to provide checks alongside the statutory auditor, but to give advice to the

management committee of the insurance company. This advice should be detailed, and should note all methods used and assumptions made. The AA should give advice on how the profitability of products can be improved, and should assess the technical risks of the company.

It is interesting to note that the AA is not expected to compute figures such as the mathematical reserves: he or she is expected to check and authorise them, but the original computation could be done by other actuarial staff. This division of tasks makes the AA's role particularly suited to an external actuary.

When should the AA give his advice to the management committee?

The AA should give reasoned advice on every new or modified product before implementation. The AA should also give advice annually on the profitability of the products, the reserves held by the company, the reinsurance treaties, and the company's profit share policy.

What is the AA giving advice about ?

The AA should examine in detail:

- the tariffs of the company, especially the methods and

assumptions used

- the funding level of any pension schemes insured by the company
- the profit participation granted to with-profits policyholders
- reinsurance treaties, in particular the extent to which they are aligned with the risks borne by the company
- reserves, which should be calculated in accordance with the Royal Decree of 22 February 1991, article 11.



Karel Goossens



Jan De Roeck

Karel Goossens is the leader of the I&FS team in Brussels.

Jan De Roeck is also part of the Brussels team.

Role and profile of the Appointed Actuary

The role of the AA is growing. It is clearly the intention of the Belgian

Insurance Authorities for the AA to add value to insurance companies and to become a close and first-class adviser of management. The Royal Association of Belgian Actuaries recognises in its professional guidance that the main aim of the AA system is that management receive advice that is independent and expert.

In effect, the AA is to be involved at all stages of the 'control cycle' - from data checking and parameter validation, through modelling and computation to monitoring and associated management advice. The AA can add value to the company at all these stages, for instance with:

- rigorous testing of quantitative data
- risk analysis, using sophisticated modelling tools
- monitoring the company's performance with reference to benchmarks representative of the market
- advice to the company with concrete suggestions regarding any problems indicated by these analyses.

To be able to fulfil this demanding role, the AA should meet certain criteria:

- the AA should be responsible - the AA should be acting in an environment offering enough



comfort to assume the role, and should have adequate professional liability cover

- the AA should have adequate experience - sound practical experience of all aspects of the insurance environment to bolster good theoretical knowledge
- the AA should have adequate resources - both adequate staff resources and appropriate computational tools
- the AA should be independent.

Conclusion

The Belgian regulators want to ensure that the right controls are in place. They do not believe that the simple screening of accounts is

adequate in deciding on the security of an insurance company.

The management of insurance companies have to cope with difficult business objectives and a complicated legal environment; they need the advice of an expert who understands the complex financial dynamics of insurance operations, and who can advise - whether from inside or outside the company - on the strengths and risks of their business. The Appointed Actuary is to be this expert, an expert who can add considerable value to the financial management of the company. ■

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The Irish Personal Pensions Market: the PRSA

Earlier this year, the Dail (Irish Parliament) passed the Pensions (Amendment) Act, 2002. This Act sets out, amongst other things, the framework for the creation of Personal Retirement Savings Accounts (PRSAs), a new pension contract aimed at improving pension coverage in Ireland.

In recent years there had been concern in Ireland over the low level of private pension coverage. Coverage was particularly low amongst the self-employed and employees in small businesses. These concerns led to the creation of the National Pension Policy Initiative (NPPI), whose task was to suggest remedies. The resulting NPPI report, published in 1998, contained a number of recommendations, many of which have been implemented in the new Act.

While the legislation has set out the framework for the operation of

PRSAs, much of the detail in relation to the operation of PRSAs will be set out in regulations which are due to be published shortly. Applications for PRSA products to be approved will be accepted from 11 November; the products are expected to be available in early 2003.

What is a PRSA?

PRSAs are defined contribution pension arrangements provided by financial services companies; they are broadly similar in many respects to personal pensions, including stakeholder pensions, in the UK. There are two types of PRSA: 'standard', corresponding broadly to stakeholder pensions in the UK, and 'non-standard'.

Standard PRSAs differ from non-standard PRSAs mainly in having an explicit maximum limit on charges of 5% of each contribution received and 1% per annum of the assets held. As with UK stakeholder arrangements, employers must generally offer access to a standard PRSA to employees unless the employees are eligible to become members of an occupational scheme. Compared with the UK, a wider range of employers will be subject to this requirement.

In recognition of the maximum charges and the likely methods of distribution, a standard PRSA will have less onerous disclosure

requirements at the point of sale than will non-standard versions.

Product design

As with the existing pension arrangements, tax legislation sets the limits on contributions and the timing and form in which benefits may be taken. However, the new Act places further - and considerable - restrictions on the design of a PRSA product including:

- All charges must be expressed only in the form of percentages of contributions and percentages of assets.



Colin Murray

Colin Murray has recently joined Watson Wyatt's Dublin team, and has specialist knowledge of personal retirement savings products.

- No charges are permitted on termination of a PRSA contract, or on contributions arising from transfers from other pension arrangements.

■ Where a provider sets a minimum acceptable contribution, this cannot be greater than €300 per annum or €50 per transaction (€10 for electronic transfers).

Investment restrictions

All PRSAs are required to offer a default investment strategy that is applied unless the individual contributor actively opts out of that strategy. The default investment strategy must, apart from limited holdings in cash, involve investment only in pooled funds, including internal linked funds of life insurers. The pooled funds used must meet criteria intended to protect consumers relating to diversification, liquidity and equitable unit pricing. These restrictions apply to all investments held in standard PRSAs, whether or not within the default investment strategy.

Who can provide PRSAs?

Under the terms of the Act, a ‘PRSA provider’ may be an authorised investment firm, a life insurer or a bank (or other credit institution). Life insurers authorised to sell into Ireland under freedom of services or freedom of establishment are also eligible. No specific approval is required to become a PRSA provider; however, each PRSA product must be approved individually.

PRSA regulation

The approval and supervision of PRSAs is undertaken jointly by the Pensions Board and the Revenue

Commissioners. Applications to sell PRSAs must be submitted to both. The Pensions Board is responsible for the regulation of occupational pension schemes and, under the Act, the regulation of PRSAs.

The Act also creates a new role for actuaries: the ‘PRSA actuary’.

Issues for financial services companies

Non-insurers

A notable feature of the PRSA regime is that it is open to participation by a wider range of financial services companies than is

“It is unlikely that there will be a sustainable ‘one size fits all’ charging structure...”

The PRSA actuary will have responsibilities relating particularly to the operation of the default investment strategy and to product disclosure. The Society of Actuaries in Ireland has been given a statutory responsibility to draw up guidance for the role of the PRSA actuary.

The Act imposes the disclosure of charges and commissions pre- and post- sale of a PRSA contract. These details must be contained in a ‘Preliminary Disclosure Certificate’ followed by a ‘Statement of Reasonable Projection’. There are ongoing requirements to give periodic statements of account and projections to consumers. For individuals considering transferring accrued funds from an occupational scheme to a PRSA, there are particularly onerous disclosure requirements.

the existing retirement annuity contract regime, which has been dominated by life insurers. Many types of organisation may have a role in manufacturing or distributing PRSAs.

The charging structure of standard PRSAs may particularly suit investment managers wishing to use unit trusts and similar vehicles to produce individual pension products for both the retail and corporate pension products. Indeed, the system of maximum charges may favour investment managers over life insurers, who will be required to hold more capital to back such products because of the required minimum solvency margins imposed by the EC Life Directives.

For institutional investment managers there may be opportunities to provide pooled

funds on a wholesale basis to be used in PRSAs offered by other companies. There is evidence from the UK stakeholder market that, where a pension product is tightly defined by legislation, a wide choice of investment managers can act as a useful form of product differentiation. Investment managers will, however, need to assess carefully the structure of their funds to ensure that they fit within the restrictions of the PRSA legislation, especially those restrictions relating to charges.

Pressure on margins

The charges permitted under the standard PRSA contracts are less than those currently imposed by most life insurers. Some commentators expect that the majority of the PRSA contracts sold will be of the standard PRSA variety; if so, there will be a fall in margins for pensions business for most life insurers.

For larger premium sizes, especially for single premiums, competition is likely to lead to higher allocation rates and/or lower management charges. It is unlikely that there will be a sustainable 'one size fits all' charging structure, and so there will be little opportunity for cross-subsidies between small and large premium policies.

Once PRSAs are introduced, it is possible that they may be viewed by customers as the benchmark charging structure. This could lead to lower charges for non-PRSA



pension contracts, and even a reduction in charges for existing in-force pension policies. It is also possible that the introduction of PRSAs will lead to lower charges on non-pension investment products.

Expenses

Because of falling margins, expense reductions will be required to achieve profitability. This is a challenge for life insurers -

especially given the size of the Irish market, where it will be difficult to achieve significant economies of scale. In order to achieve the necessary expense reductions, it will be important for companies to use technology effectively to ensure that the business is run as efficiently as possible. The disclosure and ongoing communication requirements demanded by the Act further reinforce the importance of technology.

Distribution

It is difficult to see how, in the long term, it will be worthwhile for some of the more traditional sales channels to sell PRSAs. Low margins are likely to lead to lower sales remuneration. Standard PRSAs may become commodities requiring little advice and, in that case, the

distribution of stakeholder pensions products. For a variety of regulatory and practical reasons, many of these failed to materialise or to live up to their early promise. The advent of PRSAs may likewise lead to a wave of experimentation in Ireland with new methods of distributing financial services products.

even then not as part of the default investment strategy). This may be one factor encouraging some life insurers to continue to offer retirement annuity contracts. However, opportunities may exist to develop synthetic with-profits funds, and other forms of limited volatility funds, within the constraints of the PRSA legislation to take the place of the traditional with-profits product.

“Life insurers can learn from the UK’s recent stakeholder pension experience...”

cheapest distribution channel will be the most effective. It is likely that bancinsurers, companies with access to the corporate market, and companies with a successful direct-response distribution capability will have the lowest cost base, and so may be the winners in selling standard PRSAs.

For non-standard PRSAs, larger standard PRSAs, and transfers from other pensions contracts, it is likely that advice will be required; extra margins arising from higher premiums may make commission or other sales remuneration more affordable for these cases. A greater role may therefore be played by the broker channel for this type of PRSA business. Some shift to fees or level commissions is also plausible.

In the UK, there was some initial enthusiasm for novel forms of

Lapses

In the absence of any exit penalties, there will be no disincentive for customers to transfer their policies elsewhere: increased lapse rates may ensue.

The introduction of PRSAs may also affect the lapse rates on existing contracts - policyholders may switch to PRSAs from their existing contracts. However, as many existing contracts are front loaded, it may not make sense for customers to transfer; it will be important for life insurers to ensure that customers understand this.

With-profits

With-profits funds in the form currently offered by life insurers will have only a limited use in PRSA products, as they can be offered only in non-standard PRSAs (and

Conclusion

The introduction of the PRSAs creates both problems and opportunities for domestic and EU life insurers and other potential PRSA providers. Life insurers can learn from the UK’s recent stakeholder pension experience - in particular, the ways in which that experience differed from expectations.

The PRSA initiative will be judged on the improvement in pensions coverage within the Irish population. If the PRSA initiative is not successful, the Government has indicated that it will consider introducing some type of mandatory provision. If it is a success, it will strengthen the role of financial institutions in helping to address Irish society’s needs. ■

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Watson Wyatt: putting clients first

Defined contribution pensions

Watson Wyatt announces the publication of *An introduction to Defined Contribution pension plans in Europe*.

This 60 page report describes the defined contribution pensions markets in 17 countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and UK. The report examines the market in each of these countries in some detail, and provides summary Europe-wide comparisons and favourability analyses.

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Healthcare services

The Insurance and Financial Services practice is proud to announce a strengthening of its healthcare team. Our recent appointment of three experienced healthcare specialists allows us to improve our service to insurers, financial services organisations and healthcare providers.

In keeping with this expansion, we shall be issuing our sister publication Healthcare Market Review more frequently than before. The most recent issue included the following articles:

What's in a name? Mike Williams, who has recently joined Watson Wyatt from Guardian Health, discusses the construction of integrated healthcare products.

Experience monitoring Sue Elliott, who has recently joined Watson Wyatt from Swiss Re Life and Health, explains the role of experience monitoring in ensuring adequate product pricing.

Product pricing policy Andy Sanders compares the healthcare product pricing of various insurers.

Disability, absence and productivity management in the US Karen English outlines recent developments in the US healthcare market.

For further information on Watson Wyatt's healthcare services, or to subscribe to Healthcare Market Review, please contact Sue Elliott, Andy Sanders or Mike Williams in our Reigate, UK office on +44 (0) 1737 241144.

Healthcare Market Review can be downloaded from our web site www.watsonwyatt.com

Forthcoming Watson Wyatt seminars

Event	Location	Date	Contact
GLMs in non-life premium rating: theory and practice	Chicago	17 September	Claudine Modlin Duncan Anderson
Postcode zoning in non-life premium rating	Paris	19 September	Jean-Marc Bonifacio Duncan Anderson
Fair value in life insurance	Budapest	24 September	Gyula Horvath Michel Abbink
Embedded values in life insurance	Paris	24-25 September	Jean-Marc Bonifacio Neil Taverner
Dynamic financial analysis in general insurance	Paris	1 October	Jean-Marc Bonifacio David Slater
Asset-liability management in life insurance	Paris	15 October	Jean-Marc Bonifacio Neil Taverner
Postcode zoning in non-life premium rating	Madrid	16 October	Manuel de la Rosa Duncan Anderson
Postcode zoning in non-life premium rating	Barcelona	17 October	Manuel de la Rosa Duncan Anderson
Postcode zoning in non-life premium rating	Milan	6 November	Matthew Edwards Duncan Anderson
Embedded values in life insurance	Luxembourg	7-8 November	Karel Goossens Jean-Marc Bonifacio
Fair value in life insurance	Paris	19 November	Jean-Marc Bonifacio Michel Abbink
Distribution strategy	Paris	3 December	Jean-Marc Bonifacio Frank Fletcher
Fair value in general insurance	Paris	17 December	Jean-Marc Bonifacio Catherine Cresswell

To contact speakers for information about these events, please e-mail firstname.lastname@eu.watsonwyatt.com

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