The Insurance Business Model - What Will the Future Bring?

13. June 2013

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1. Introduction

- Why is it so difficult to estimate future developments?
  - Unpredictable changes in customers’ behavior
  - «Unexpected» technical revolutions

- Focus on the insurance industry:
  - Adherence to analyses based on retrospective views
  - «Urban myths»
Myths and misjudgements

“The global demand for cars will never be above 1 million – simply because there are not enough chauffeurs”

(Gottlieb Daimler, 1900)
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• Let us try to shake off our assumptions regarding the future demand for «chauffeurs»

• Focus on four key aspects:
  - Insurance pricing (Chapter 2)
  - Business model of life insurance companies (Chapter 3)
  - Regulation of the insurance industry (Chapter 4)
2. The insurance companies’ pricing will change drastically

- Price communication: presentation of price towards the client
  - Absolute, relative, broken down by its components, in combination with other products etc.
  - Actual price and its perception by the client (Exp.: Media Markt, Praktiker, Lidl)
  - Basis: framing effects
  - Price communication is influenced by the companies‘ strategic price positioning

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- Price communication: What does the insurance industry do?
  - Cost-oriented pricing (see discussion regarding „unisex rating“ in the EU)
  - Customers‘ willingness to pay is rarely taken into account
  - Different distribution channels with slight price differentiation
  - Moderate transparency regarding price and performance
  - „Law of one price“ does not apply in the insurance sector
  - Rarely price component breakdowns (pressured by regulator)
  - Price presentation in absolute form (prices not time sensitive)
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1. Example: Comparis CH

<table>
<thead>
<tr>
<th>Automobile Insurance</th>
<th>Health Insurance (OKP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jahresprämie</td>
<td>Monatsprämie</td>
</tr>
<tr>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>856</td>
<td>302</td>
</tr>
<tr>
<td>978</td>
<td>421</td>
</tr>
<tr>
<td>1,096</td>
<td>525</td>
</tr>
<tr>
<td>1,106</td>
<td>+74%</td>
</tr>
<tr>
<td>1139</td>
<td>+39%</td>
</tr>
<tr>
<td>1,197</td>
<td></td>
</tr>
<tr>
<td>1,315</td>
<td></td>
</tr>
</tbody>
</table>

Audi A3, HP mit BS, TK mit SB 0, KK mit BS und SB 1'000, Pers. Eff., Unfall
Standard OKP Zürich, F 300, ohne Unfall
1. **Example: Automobile insurance Germany**

Audi A4, parameters as in CH-offer for Audi A3
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1. Comparison with other industries

<table>
<thead>
<tr>
<th>Angebot</th>
<th>Leistungs-Bewertung</th>
<th>Bonus-Bewertung</th>
<th>Kunden-Zufriedenheit</th>
<th>Jahresprämie CHF</th>
<th>Sparpotential CHF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angebot 1</td>
<td>6.0</td>
<td>4.7</td>
<td>4.9</td>
<td>3'223.20</td>
<td>3'366.70</td>
</tr>
<tr>
<td>Angebot 2</td>
<td>6.0</td>
<td>4.7</td>
<td>5.0</td>
<td>3'393.70</td>
<td>3'196.20</td>
</tr>
<tr>
<td>Angebot 3</td>
<td>6.0</td>
<td>4.6</td>
<td>4.9</td>
<td>4'914.30</td>
<td>1'875.60</td>
</tr>
<tr>
<td>Angebot 4</td>
<td>5.8</td>
<td>5.3</td>
<td>5.3</td>
<td>5'767.50</td>
<td>822.40</td>
</tr>
<tr>
<td>Angebot 5</td>
<td>5.9</td>
<td>4.3</td>
<td>5.2</td>
<td>6'862.00</td>
<td>527.90</td>
</tr>
<tr>
<td>Angebot 6</td>
<td>5.9</td>
<td>4.6</td>
<td>5.0</td>
<td>6'178.90</td>
<td>411.00</td>
</tr>
<tr>
<td>Angebot 7</td>
<td>5.9</td>
<td>4.6</td>
<td>5.0</td>
<td>6'435.40</td>
<td>154.50</td>
</tr>
<tr>
<td>Angebot 8</td>
<td>6.0</td>
<td>5.3</td>
<td>5.3</td>
<td>6'589.90</td>
<td>0.00</td>
</tr>
</tbody>
</table>

- quasi homogenen product
- + 100 %

Omega watches : Ebay / juweller

Opodo flight tickets Zurich-New York
1. This is astonishing, especially since policyholders perceive insurance companies as interchangeable …

Source: BrandAsset™ Valuator – Schweiz – Versicherungen – Gesamtbevölkerung
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1. ... policyholders tend to consider themselves as price sensitive ...
1. ... and insurance companies associate changes in their customers’ behavior with increased price sensitivity
2. I.VW study: Premium breakdowns and different forms of price presentation hardly have an impact on the demand

<table>
<thead>
<tr>
<th>PRICE BUNDLING FACTOR</th>
<th>PRICING OPTIC FACTOR</th>
<th>No Guarantee</th>
<th>Guarantee level at maturity of the contract: 12,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bundling ($P$)</td>
<td></td>
<td>100</td>
<td>644 first month then 100 105 1% p.a.</td>
</tr>
<tr>
<td>Partial bundling</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Base contract($P$)</td>
<td></td>
<td>100</td>
<td>100 100 105</td>
</tr>
<tr>
<td>Inv. guarantee costs ($P_G, \alpha$)</td>
<td></td>
<td>0</td>
<td>544 up-front 5 1% p.a.</td>
</tr>
<tr>
<td>No bundling</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk premium($P_D$)</td>
<td></td>
<td>1</td>
<td>1 1 1</td>
</tr>
<tr>
<td>Savings premium($P_S$)</td>
<td></td>
<td>91</td>
<td>91 91 96</td>
</tr>
<tr>
<td>Administrative costs($kP$)</td>
<td></td>
<td>8</td>
<td>8 8 8</td>
</tr>
<tr>
<td>Inv. guarantee costs ($P_G, \alpha$)</td>
<td></td>
<td>0</td>
<td>544 up-front 5 1% p.a.</td>
</tr>
</tbody>
</table>
2. Nevertheless, regulators request this as part of a «transparency campaign»; the insurance industry remain critical towards breakdowns.

- In other industries, breakdowns have a substantial impact on the customers’ purchasing behavior.

For a rational decision, solely the total price is relevant!

DUS-MNL via AMS; price breakdown:

- Adult
  - Ticket Price 482.00
  - Ticket Service Charge - Fuel Surcharge 260.00
  - Civil Aviation Tax 45.00
  - Airport Tax for Passenger Service 15.27
  - Security Charge 14.50
  - Airport Tax for Passenger Service 12.66
  - Noise Protection Surcharge Netherlands 4.00
  - Airport Security Tax 3.89
  - Total Price EUR 837.32

Number of Passengers 1
Extreme case: price communication at airlines

- Differs from the insurance industry’s price communication in every aspect

Examples:

- Pricing is based on the customers’ willingness to pay
- Capacity-oriented price determination
- Pricing is strongly time dependent (remaining time until departure, time of the day, day of the week etc.)
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• Cost-oriented pricing in other industries
  - Example: Porsche 911 versus 911 S
  - Price: 123‘000 CHF versus 141.300 € (2013)
  - Clear focus on the customers‘ willingness to pay

Link to the discussion about «unisex rating» in the EU:
Proof of an input factor’s significance with regard to the product price in other industries?
Hypotheses regarding the pricing in insurance companies

- The pricing of insurance products is about to be revolutionized: In the future, pricing will be based on the customers’ willingness to pay and optimal «price – quantity – combinations»

- Actuarial pricing (solely) used to determine lower price limits

- The market will be become more competitive. The products, however, will develop rather less homogenously

- The market will be characterized by supplementary services (which in return will result in inhomogeneity)
3. Life insurers’ business model under pressure
Current study of I.VW

- Customers seek long-term investment guarantees
- However: Is their willingness to pay sufficient to cover the costs?
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- Obtaining the guaranteed interest proves very difficult

![Graph showing the development of the working interest rate and the guaranteed interest rate in percent. The graph indicates that the guaranteed interest rate has significantly decreased over time, with flat yield currently below 1%.](image)
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- Investment structure of a life insurer – very few degrees of freedom

With **Solvency II** and the requirement of a minimum interest rate follows strictly the adjustment of the amount of the equity capital \( E_0 \) and at the same time the derivation of the investment structure \( \gamma \).
Save investment (100% risk-free)

\[ r_f - g \rightarrow 0 \]

\[ r_f \rightarrow g \]

No scope for risky but promising investments
⇒ “forced” investment structures in practice solely safe at first sight, since hardly diversified

Minimum interest rate guarantee practically worthless; Inv. mglw. unfavorable compared to direct investment; investment portfolio without potential regarding profit participation
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- Just a vague theory?
Hypotheses regarding the future of combined endowment insurance

- In the current situation, this product loses its attractiveness (option practically worthless, profit participation limited)
- Financing of this business model is hardly possible from the stakeholders’ point of view
- Scenarios: Interests go up? Lowering of the guaranteed minimum interest rate?
- Insurance industry will switch to alternative saving products, a delimitation with regard to the investment funds industry is mandatory
- Pressure on transaction costs (also applicable to other divisions) will increase drastically
4. Regulation in the insurance industry

Figure 3
In what parts of the business environment do you expect the biggest changes to occur for the insurance sector over the next five years?

- Regulation trends for the insurance industry
  - Demographic changes (e.g., aging customers, aging workforce)
  - Increase in provisions and regulations in the customer relationship
  - Development of capital markets (e.g., interest rates, stock markets)
  - Revamping of social security systems
  - Increased individualization and decline in solidarity
  - New technologies (e.g., digitalization, pervasive computing)
  - Altered communication behavior / new media
  - Pressure from consumers
  - Increased environmental damage
  - Structural shifts within the industry (mergers and acquisitions)
  - Globalization / advent of international markets
  - Pressure from investors / analysts
  - New market players
  - Environmental technologies / genetic technologies / life sciences
  - Share of environmental areas responsible for change in %

- Life insurance
- Nonlife insurance
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- Solvency II (2017?)
- Reform of VVG and insurance brokerage directive
- Unisex rating in the EU
- EU insurance guarantee fund

• Re-regulation
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• Solvency II (2017?)

- Current I.VW study: Nothing truly fits in the standard model, impacts on the insurers’ asset allocation are absurd from an economic point of view; in addition: the actual ruin probabilities differ substantially from 0.5%; the absence of an obligation to deposit in the context of government bonds in the EU is politically motivated, with regard to stability of the system very dangerous

- Unisex rating in the EU

- Current I.VW study in 5 European countries: The application of „gender“ as a rating element is not perceived negatively by the customers

- Insurance brokerage directive

- Despite estimated costs summing up to a three-digit million figure, there is no analysis whether the insurance brokerage directive resulted in better-informed customers
• Hypotheses regarding the future of insurance regulation

- There needs to be and there will be a trend towards “better” and not “more” regulation

- Regulative concepts will have to undergo a well-founded cost-benefit analysis

- In my opinion, the continuation of the existing quality standards of re-regulation can be ruled out
5. Summary and outlook

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MOMENTS OF TRUTH

SOCIAL MEDIA MONITORING
SHOWS THAT WHAT
CONSUMERS REALLY WANT
ARE CAT BLOOPERS,
FARMVILLE, AND LADY GAGA

BUT WE SELL
TERM LIFE
INSURANCE
SORRY,
THAT’S NOT A
TRENDING
TOPIC

LIBERATING CONSUMER INTELLIGENCE. EMPOWERING MARKETERS.

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by Tom Fishburne

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