Adapt or die: the basics of success in Life?
Mark Tucker, Group Chief Executive, Prudential
Speech to Merrill Lynch Banking & Insurance Conference, 5 October 2005

I am going to be sharing some initial thoughts about the longer term opportunities for Prudential at a presentation on the 26th October. That being the case you will understand that it is not appropriate for me to be talking today about strategies specific to Prudential. Today I am talking solely about the UK life industry. Prudential is a large financial services group with a significant and material international presence, and with a banking and mutual fund business in addition to its UK life business.

I gave this session the title of ‘adapt or die’ because I don’t see that all companies will overcome the challenges ahead. Indeed we are already seeing the pace of closures and concentration growing in the UK. We all know that the UK life industry has been subject to extraordinary rapid change over the last 20 or so years and that there have been casualties.

Therefore, what is it going forward that will distinguish the winners from the losers? Before I answer that question I want to look at some of the trends over the last 20 years and make some points about where we are now that I think are relevant to the future.

First, we’ve seen a dramatic decline in the number of active insurance funds especially in traditional With Profits and Industrial Branch funds.

Second is the changing distribution mix that’s been caused by the closing down of most agency and direct sales forces. Today we have a highly intermediated market.

Third, we’ve seen the shift from a high inflation to a low inflation economy in the UK. That in turn leads to lower growth rates - in nominal as opposed to real terms and it heightens the importance of cost efficiency in distribution and administration particularly if consumers are to see their investment funds grow ahead of deposit accounts.

Next, there is the loss of consumer confidence. Trust in the products of the financial services industry is low. This is partly because of investment performance and associated with-profit bonus cuts but clearly there is a more to it than that.

The highly publicised mis-selling scandals, the lack of transparency around contract terms and conditions, excessive charging and high profile financial failures have all played their part. This loss of confidence has been compounded by the erosion of tax incentives to save through insurance based products.

Finally, I’d highlight the growth in credit and consumption today at the expense of good old fashioned thrift. In UK market terms, consumption has historically been a cyclical factor that goes with the ‘feel good’ impact of rising house prices and high levels of employment and a misplaced belief that home ownership is an automatic and complete substitute for traditional retirement saving.

These trends, and others have led to the decline in flow of funds into life and insurance-based pension products - admittedly from a very high starting point - but that cannot simply be explained as the usual cyclical factors in operation. I’ll give you an example. The with-profits share of the market has traditionally expanded when equities are low. But over recent years, we’ve had unexpectedly low stock market prices accompanied by many with profit funds needing to cut bonuses and impose market value adjustments. This has seriously damaged their credibility as products that can be relied upon to deliver smoothed equity performance.

Increasing costs of doing business and changing customer preferences have also led to the decline in direct sales forces and therefore directly to lower volumes of saving in the mass market. In the past regular premium savings played an important role in maintaining life company premium income year on year as well as making life more comfortable for the management. This is not something that will be reversed without the development of successful new distribution models for the mass market and measures to increase demand for savings from customers.

Another factor which made life more comfortable for management was the way that profit emerged from traditional with profits business. Managers of traditional with profit funds derived their profits from the shareholder share of the bonuses added to policies. This share was typically a maximum of 10% hence the term ‘90:10 fund’. This process resulted in a steady flow of profits and shielded the Management from the ups and downs of the investment market and the variability of other day to day business impacts. The fact that we’re all living longer, for example is actually very good news, not only for us as individuals, but it also presents wonderful opportunities for us as a life insurance company! All these factors add up to a major challenge to the life industry’s traditional assumptions and the context in which it does business.

In some ways it can be regarded as a normalisation process. By that I mean that as an industry we’ve got to become much more like other types of commercial enterprise than we used to be. Some of us have already made some progress in this area. In large part, this has resulted from the fall from grace of 90:10 with-profits business and the rise in shareholder backed business. That would be my first step for ‘adapt or die.’ Get real and stop living in the comfortable past!

So how do I think companies will survive? What exactly do I mean by this? Well, my starting point is that the required financial management capabilities of traditional life companies are transformed. Until recently most with profit and unit-linked life funds were expanding, and from a taxation point of view this has great advantages compared with a fund with a cash outflow. There is a need to be incisive about controlling both unproductive acquisition costs and ongoing renewal costs. As sales reduce, the decline in acquisition costs can sometimes distort the view of the well-being of a life office. That's because it results in a temporary improvement in the company's finances as the new business strain is reduced. Now this is, of course, an illusion over the longer term but it can lure management into delaying necessary and decisive action often with fatal consequences as they hope things will turn around for the better.

In addition, with declining volumes as sales reduce and surrenders increase, it is difficult to control unit costs and strenuous efforts are needed to minimise admin expenses and particularly legacy systems costs. It may be counter intuitive but it is more important, not less, to count candle ends.

You may say that this is all good housekeeping. But how consistently is it managed to those strategic horizons across the sector? Criticisms of with-profits have caused a desire to reduce opacity and unwelcome surprises. As a direct consequence we've seen an increase in the need for shareholder capital to back a new generation of more attractive products in the UK - be they unit linked investment bonds or protection business. For all practical purposes shareholders are looking at a business where revenue less expenses and claims equals profit.

This makes the insurance company business model much closer to other commercial businesses profit and return on capital as the basis for managing the business. As well as bringing into sharp focus the treatment of expenses it also puts the emphasis back onto reward for successful and measured risk taking. This has required insurance companies to adapt to running their businesses very differently from how they did so in the past. In particular management of capital becomes a critical competence. And this is another key 'adapt or die' issue.

So what is the recipe for success? Turning from the past to the future it is a truism to say that survival depends on a passionate focus on customer needs and getting product and distribution strategy right. As I've just said, running an insurance business is becoming much closer to running other commercial businesses! But what does this involve? If what I have said so far is sound then it is unlikely that many traditional life insurers will get by let alone be successful, on a 'business as usual' basis. But even if that obstacle can be overcome this is only the start. To survive, we in the Life Industry face many more fundamental challenges such as:

- Restoring consumers' confidence
- Persuading consumers of the need to insure and save and to do so via life insurance

- Delivering and persuading the customer, that we give value for money, and ……
- Persuading consumers to become more active in planning for their long term financial needs

These are major challenges and they require the industry to rise to the challenge or die. I fully accept that consumer confidence in our sector has been eroded. The challenge we face to restore confidence is difficult but it's not impossible. We've got to simplify the rules governing the provision of products. We've got to simplify the products themselves to make them easier for consumers to understand and to buy. We've got to promote adequate financial literacy and we've got to help consumers to understand what they can - or more to the point what they CANNOT - expect from the state. And we've got to help consumers to know where they are in terms of their own savings and indebtedness. People have got to understand the need to save …. and then feel confident that it will pay to save. To instil that confidence the Government has got to resolve the issues around means tested benefits and suitability and the industry has got to produce value for money products that consumers can trust. All this requires bold new thinking. It requires courage, a clear vision and it requires real action.

It's not realistic to expect consumers to become financial experts. But I believe that it's in consumers' best interests, as well as in the best interests of the industry for them to have some basic understanding of financial concepts including the nature of risk and for the industry to play a part in encouraging that. At Prudential we've got a programme committed to financial literacy. This includes working closely with Citizens Advice, National Institute of Adult Continuing Education, Specialist Schools Trust and the Scottish Council Foundation. In addition part of the 'Plan from the Pru' is education. We have over 20 free pocket planners which are designed to help customers think more about many of life's key financial decisions and plan for a more secure future. Such programmes are not a panacea but they should equip consumers to make more informed choices - especially about the relationship between savings and future returns. And when they feel confident enough to do so, we, as an industry, should be there with a range of lifestyle options to meet their individual needs.

Greater efficiency, and improved education will come from massive simplification, transparency and standardisation. This should lead to better value products and safer sales processes and that in turn will lead to a reduced need for complex and costly sales regulation.

To meet the changing needs of our consumers, what are the products that the successful life insurer will have to have in 10 years time? Well, if we start with customer need the stock answer is 'to bridge the savings gap' with particular focus on saving for retirement and income in retirement. Now, I am certainly not going to argue against this other than to point to a real need for 'protection products' - term insurance, illness and healthcare - in much greater quantities and more specifically attuned to lifetime needs than at present.

We don't know what the final outcome of the Pensions Commission will be in the UK but all the indications are that the greater part of the new funds flowing into pensions immediately post-A day next April will come from the mass affluent and high net worth customer segments and increasingly will be into 'pension wrapper' SIPPs invested onwards into mainstream Unit Trust and OEIC products and into various types of property.

The Pensions Commission may also suggest solutions for mass market savings which favour the fund management industry. We also need to recognise that life insurance based products are currently disadvantaged with regard to capital efficiency when compared with the mutual fund industry. With the shift to the use of shareholder capital and the inevitable focus on return on capital that I explained earlier this is becoming significant.

The logical conclusion is that over time the role of life insurance in retirement savings / income provision will increasingly be focused on doing those things that cannot be replicated effectively by other routes i.e.:

- The guaranteed return options including the simplified 'smoothed return' new with-profit products
- Longevity insurance in the form of conventional annuities.
- Pensions in payment with a broader mix of US annuity type vehicles and revitalised with profits annuities to allow people greater scope to manage their own income in retirement and benefit from a broader spread of investments.

Life Insurers will also use their longevity risk management skills to underwrite reliable and predictable home equity release schemes albeit through separate lifetime mortgage companies.

Turning to distribution? Again, what is likely to happen over the next 10 years? Today Independent Financial Advisers have become a major source of medium and long term savings business. They are likely to continue to be the choice of the high net worth and to a proportion of the mass affluent customer segments. And we are likely to see increasing specialisation here post A-day with greater demand for tax and inheritance planning advice, and a steady increase in the range of integrated advice that needs to be provided - a factor that will tend to reinforce their focus on servicing high net worth individual needs. IFAs will go through considerable transformation because of the implementation of regulatory changes; and if the period after 1986 is anything to go by these will take some time to work through the system. It is not as simple as an overnight change of status. These will include the development of multi-tied panels by IFAs and banks.

I predict that a fair proportion of IFAs will multi-tie and evidence to date supports this with Bankhall, Sesame, Millfield and Thinc Destini all announcing multi-tie panels. Prudential has secured a place on each of them.

I also believe that we will continue to see a substantial proportion of business through the intermediated channel. There ought in theory to be a further shift towards fee based advice but so far this has proved to be one of the major challenges, and one which the mass market in particular has resisted. The insurance industry has made life very difficult for itself by talking over many years about 'free advice'. Considerable work will also be required in building e-commerce and e-commerce linked with telesales capabilities as well as in developing the wrap and portal concepts.

Expectations in the dot.com boom of the average customer converting overnight to become a self starting on-line buyer of complex pensions products were overdone but the underlying trend remains, with comfort levels in buying simpler 'bought' products, rising.

I believe there will be a further effort to make the regulatory changes originally suggested by Ron Sandler work. Banks are extremely well placed to provide these simple products and use their branch staff to adopt the cheaper and streamlined sales processes. It remains to be seen whether the volumes of mass market business sold through these channels are sufficient to reverse the trend towards full-time 'professional' advisers focusing on affluent consumers back towards a distribution basis that is commercially viable for the mass market.

Our experience has shown that worksite marketing similarly has the potential to be one of the most effective means of reaching large numbers of employees and encouraging them to think about saving and protection through a range of simple and tailored products. Re-vitalising the mass market will require companies and the FSA to develop a simplified sales process a sales process that allows consumers to buy products safely and easily on a 'one interview and done' basis with an adviser.

As well as these developments in retail distribution I believe we will continue to see a growth in wholesale distribution. There is an estimated £760bn in UK private defined benefit pension assets and with employers increasingly concerned with the cost of maintaining these schemes the market for pension scheme bulk buy-out and risk management deals shows real growth potential. The key to success will again be efficient capital management. It will require the insurance industry to work in partnership with the capital markets and, dare I say it, for the capital market to embrace longevity risk. In addition we will continue to see insurance company rationalisation deals particularly around back books of business.

The element common to all of the 'insurance' products - protection, annuity and healthcare - in 10 years time is a higher underwriting risk bearing content than we've seen in the past.

Life insurance will then return, to a much greater extent than in the recent past, to being focused on making profits from conservative exposure to risk properly priced.

That will put the emphasis back onto reward for successful risk-taking as a primary driver of profit, and successful management of capital allocation to support profitable opportunities and capture returns. This will open a gap between the survivors who can do this successfully…. and the non-survivors who do not understand that the game has changed until it's too late. And that game has already started!