Article from

Reinsurance News

July 2016
Issue 85

How Can Life Insurers Improve the Performance of Their In-Force Portfolio?

A Systematic Approach Covering All Drivers Is Essential

By Andrew Harley and Ian Farr

This article is reprinted with permission from the March 2013 Emphasis *magazine.*

In-force portfolios are a valuable but often neglected asset that life insurers should manage carefully as they meet the challenge to improve returns.

Life insurance carriers continue to build new products or enhance existing ones, hire more agents and look at new distribution methods or markets; however, over the last several years we've seen an increased number of carriers focusing on improving the performance of their in-force business. AXA, VOYA, Allianz, Genworth and John Hancock are just a few companies who have made recent announcements regarding actions taken related to certain in-force blocks and we expect this activity will continue to increase.

This article will explore how carriers are no longer taking a single thread approach when analyzing and improving in-force blocks. While they will continue to look at reducing operational costs or transfer liabilities, we see insurers following a more holistic and diagnostic path to analyzing in-force business.

In-force portfolios have traditionally provided life insurers with a steady and reliable stream of earnings, making a significant contribution to respectable industry margins. However, these margins are now under pressure as a result of the retention and return implications of prolonged low interest rates. Insurers need to recognize that because of the scale of their in-force portfolios, a relatively small incremental improvement in in-force performance can significantly impact bottom-line earnings and the value of the business as a whole. Willis Towers Watson's recent analysis of the embedded-value statements of major insurance groups indicates that a sustainable 10 percent reduction in management expenses or in overall lapse rates can increase the embedded value by up to 6 percent. These percentage performance gains can be significantly improved if insurers use a targeted approach to in-force portfolio management, given the wide variety of customer and policy characteristics that exist within life insurance portfolios.

There are many ways insurers can improve the performance of their in-force portfolios, and Figure 1 sets out the key drivers typically considered.

Figure 1. In-force portfolio performance drivers

Let's first look at the fundamentals—how to assess and prioritize opportunities for performance and value enhancement. Then we'll review how insurers can adopt analytical techniques to better understand retention drivers and tailor customer interactions to ultimately improve portfolio profitability. Finally, we'll address how insurers can manage the in-force liabilities to enhance their runoff value.

ASSESS AND PRIORITIZE OPPORTUNITIES

Given the range of available performance improvement opportunities, insurers will need to prioritize their actions based on considerations such as financial impact, implementation timelines and the enterprise risks involved. The financial impact analysis will typically examine a range of accounting bases that might include local regulatory, GAAP, current and anticipated IFRS, and embedded value. For some opportunities, such as retention management, different metrics can produce very different results and potentially drive different management actions. For an in-force portfolio, selection of more economic metrics, such as embedded value, as the primary drivers of decision making will typically align actions more closely with shareholder value. Often the impact of any actions on cash distributions to shareholders will also be an important decision driver.

In addition to the selection of primary decision metrics, analysis of performance improvement opportunities will generally require portfolio results to be analyzed at a more granular level than is typical within regular reporting processes. Additional investigation will likely be required to ensure the appropriate allocation of revenue items at a more detailed level, including consideration of the impact of marginal changes in the portfolio. For example, the allocation of expenses and capital at granular and realistic levels requires care, reflecting fixed/variable dynamics for expenses and allowing for diversification effects for capital.

Whichever metrics are chosen to inform the options analysis, the right decision will only be made with a thorough analysis that considers:

- Short- and long-term implications of decisions (e.g., not just the current value of customers' in-force policies but their customer lifetime value, including allowance for any market cyclicality);

- Other material business issues that affect daily operations (e.g., how the cash-flow position and the profit of the business will be affected); and

- P&L and balance sheet impacts, and overall market and business strategy.

Balanced scorecards can help ensure all factors are sufficiently and fairly prioritized. Business cases can then be developed that will require input of cross-functional working groups, sub-

ject matter expertise and high-quality analytics in each of the balanced-scorecard areas specified. With a suite of approved business cases, opportunities can be prioritized and an overall program can then be established, developed and implemented to improve in-force portfolio performance.

Retention management and liability management are two of the key areas for in-force portfolio performance improvement and often appear on the list of prioritized opportunities.
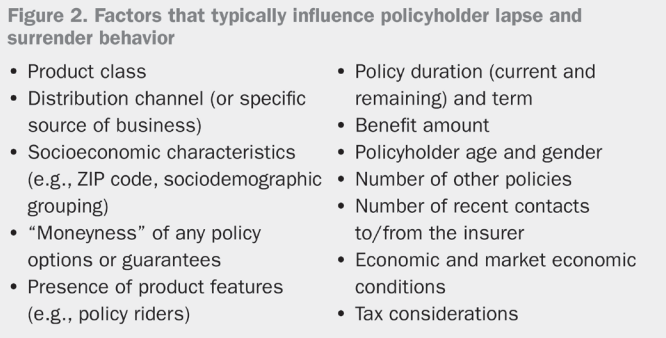
TARGETED RETENTION MANAGEMENT

Targeted retention management is the process of measuring the value of customers at a granular, segmented level, of identifying policyholder behavioral characteristics that drive lapse and surrender rates, and subsequently implementing measures aimed at retaining positive or high-value customers. Over an agreed period of time, the quality of the portfolio should improve and, along with it, the financial performance and the value of the in-force book.

Successful retention projects have a number of key stages. There first needs to be a rigorous understanding of individual customer value that reflects the value of future earnings of existing policies and the potential value of additional policy sales (a customer lifetime value assessment). This requires a good understanding of the range of variation within the portfolio (e.g., by size and cost) at a sufficiently granular level and a robust mechanism to allocate costs to products, customers and distribution channels.

Next, insurers should analyze and quantify the drivers of policyholder behavior and how they affect withdrawal rates. Technological and analytical advances have made it easier to collect and analyze data, which to date have proved difficult because of the large number of drivers involved (Figure 2), the need to allow for interactions and correlations between factors, and the sheer number of customers to analyze.

This analysis cannot be done in isolation from external market factors. Markets are dynamic, and competitive pressures or treasury/regulatory changes affect policyholder lapse behavior

Figure 2. Factors that typically influence policyholder lapse and surrender behavior

- Product class
- Distribution channel (or specific source of business)
- Socioeconomic characteristics (e.g., ZIP code, sociodemographic grouping)
- "Moneyness" of any policy options or guarantees
- Presence of product features (e.g., policy riders)
- Policy duration (current and remaining) and term
- Benefit amount
- Policyholder age and gender
- Number of other policies
- Number of recent contacts to/from the insurer
- Economic and market economic conditions
- Tax considerations

to one degree or another. These influences may be more diffi-cult to analyze, and insurers may need to apply more qualitative judgment, at least initially, to refine retention models.

Smart insurers will also seek to aggregate external (big) data with that provided by internal sources to more precisely understand drivers of withdrawal and retention rates. Bolting on data sets generated by, for example, social media sites, credit rating agen-cies and Internet distribution channels can reveal important, differentiating behavioral characteristics that can make an im-portant contribution to understanding policyholder withdrawal behavior. With so much information to analyze, firms need to use technologies and techniques that can accommodate large volumes of structured and, possibly, unstructured data. Evolving best practice uses generalized linear models (GLMs) and opti-mization techniques including propensity-to-lapse models—methods that have been used for many years by property and casualty insurers to identify and quantify the many factors un-derlying personal lines pricing and, more recently, for customer retention purposes.

The output from GLM analysis not only helps determine the factors that influence policyholder behavior, but also allows the insurer to segment customers into homogenous groups that re-spond similarly to changes in behavioral drivers. Insurers can then consider how to influence policyholder behavior in each segment to improve overall portfolio profitability. Additionally, the GLM can be used to estimate the degree to which each seg-ment will react to changes in each behavioral driver.

Insurers can then establish mechanisms to focus their retention management activities on higher-value customers. These mech-anisms depend on the market, the specific portfolio, regulatory restrictions and the results of retention analysis, but insurers can:

- Tailor written communication to the high-value policyholders to emphasize the merits of their policy, particularly over time;

- Script specific responses to inbound telephone surrender in-quiries from high-value policyholders that provide compel-ling messages to persuade them to maintain their policies, yet deliver a different message to less valued customers that may direct them to an alternative product that would benefit both parties, subject to regulatory requirements; and

- Offer loyalty programs (e.g., noninsurance-related products or voucher bundles) that are proactively offered to high-value customers and timed to coincide with high-withdrawal ex-ternal-factor changes (e.g., significant changes in investment market returns).

It is important that firms don't act solely on initial findings, but rather analyze a suitably representative sample of customers to understand the effect of these actions on policyholder behavior.

> GLMs are an excellent starting point, but human behavior is unpredictable—so it's best to learn from an initial pilot.

GLMs are an excellent starting point, but human behavior is unpredictable—so it's best to learn from an initial pilot. These activities can then be incorporated into policyholder data sets, allowing subsequent GLMs to analyze the effect on retention rates and assess their effectiveness and/or cost efficiency.
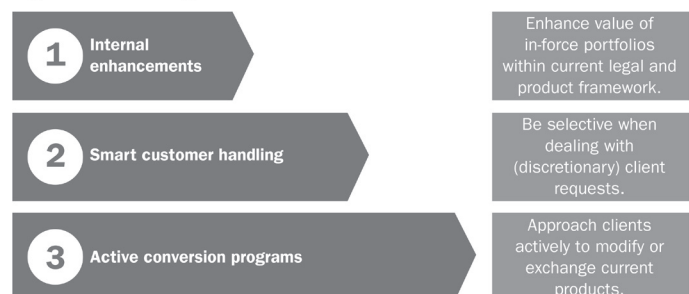
IN-FORCE LIABILITY MANAGEMENT

Liabilities can also be managed post-sale, and insurers have a va-riety of liability-driven options to influence and enhance the run-off of life insurance portfolios. We have developed three catego-ries to analyze in-force liability management (IFLM) (Figure 3).

Internal enhancements relates to the ability of insurers to change how the liabilities are managed within the current legal and regulatory framework. This includes areas where the insurer has discretion in the setting of terms and conditions, or where the insurer is voluntarily offering better terms and conditions than are legally required.

Addressing this requires a detailed comparison of contractual requirements with actual practice, invoking potentially unused insurers' rights or providing the right incentives to distribution channels to promote the desired behavior. For example, adjust-ing current Cost of Insurance Rates on Universal Life products falls into this category.

Smart customer handling means treating customers different-ly depending on the underlying financial attractiveness of their policy to the insurer. For example, for flexible premium poli-cies, an insurer might benefit from running targeted campaigns

Figure 3. IFLM categories

1	Internal enhancements	Enhance value of in-force portfolios within current legal and product framework.
2	Smart customer handling	Be selective when dealing with (discretionary) client requests.
3	Active conversion programs	Approach clients actively to modify or exchange current products.

to encourage additional premium payments and extending the policy term, with distribution partners and customer service staff encouraged and incentivized in this direction. However, for policies with high guarantees or any other onerous terms, the insurer might not encourage policyholders to make additional premium payments. In addressing these aspects, insurers should consider reviewing policyholder communication, and targeting surrender and retention management activities to reflect the value or capital consumption of different product portfolios.

Active conversion programs are the ultimate expression of IFLM. Typically, after a stringent legal process that often includes policyholder votes, an entire portfolio is converted to new policy types. These new policies exclude the problematic features of the old ones (e.g., onerous guarantees), with policyholders receiving compensation for the loss of these features.

Most countries like the U.S., however, allow conversion exercises only if policyholders individually agree to policy changes. Individual conversions generally lead to more diverse in-force portfolios and can be suboptimal, since only part of the in-force is converted or modified. Nevertheless, these conversions can be successful, as seen by programs in Germany and Austria, where clients have been successfully offered a way out of cash lock-ins under constant proportion portfolio insurance-based UL policies. Through the conversion program, their guarantees were reduced in exchange for higher upside potential, thus reinstating the originally planned characteristics of their policies and avoiding staying for the entire remaining policy duration in cash investments.

Our client experiences offer several IFLM lessons:

- One size doesn't fit all. IFLM approaches need to be tailored carefully to each portfolio's specifications, as well as to the values and objectives of individual companies, country-specific laws and the need to manage litigation and reputational risk.

- There is no silver bullet. Generally, IFLM is driven by many small steps, and only rarely do individual actions make a significant impact on overall performance. Often, only the combination of retention management, conversion offers and smart customer handling helps companies improve their situation in a meaningful way.

- Everyone should benefit. Conversion offers need to be financially attractive to both the policyholders and the insurer to attract sufficient participation. For instance, low-payment lifetime annuities could be converted to higher-payment annuities with a fixed term. Policyholders receive more meaningful annuity payments, and the insurer benefits from substantially reduced administrative costs, a reduced term and reduced longevity exposure.

CONCLUSION

Until recently, firms have given greater focus to new business activities, and resources and technology have been deployed to generate growth and (sometimes) return from new customers. For a period, at least, we believe this needs to change, and while sustained effort must continue to be applied to attracting profitable new business, more attention should be given to managing the in-force portfolio.

Any project to improve performance must be grounded in granular and robust analytics. High quality, informative analytics combined with deep business experience and local market knowledge tell us where to find and how to extract the value from an in-force portfolio that can give a much needed boost to sustainable earnings and shareholder value.

Some insurers have already implemented major in-force value enhancement projects using the activities outlined above, while others have taken this a step further and established a framework that assigns sustained responsibility and accountability for in-force value management. We believe more insurers will follow suit. ■

Andrew Harley currently heads Willis Towers Watson's advance analytics service line having previously led their business management service line. He can be contacted at andrew.harley@willistowerswatson.com.

Ian Farr is a managing director at Willis Towers Watson and a fellow of the Institute of Actuaries. He can be contacted at ian.farr@willistowerswatson.com.