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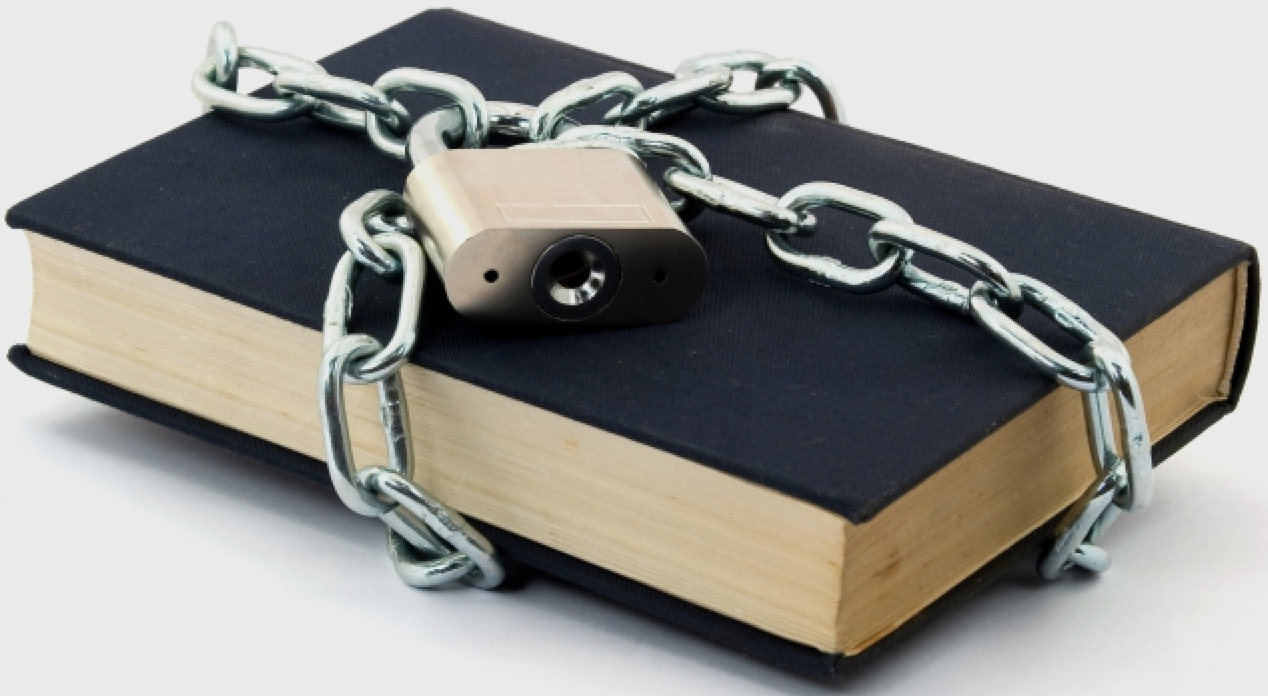
ARE CLOSED BOOKS DIFFICULT CHAPTERS FOR INSURERS?



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The life insurance business is beset by a unique challenge. The time between when a policy is sold and is eventually claimed can be unpredictably long, sometimes even decades! During this time, companies, in an attempt to streamline and rationalize their portfolios, may take some of these products 'off-the-shelf' as they turn unprofitable over time due to changing market dynamics. Termed legacy books or closed books, these blocks of policies however continue to generate premiums. Eventually, these policies mature or are paid out, and increase the run-off rate for the block of closed books.

Managing the portfolios of such policies over extended periods is a challenge for insurers both from an operational and Information Technology (IT) perspective. The overheads and servicing costs of systems managing these legacy policies become untenably high, especially as the fixed administrative costs are spread across a dwindling number of active accounts. As capital reserves should be booked against future expenses, these costs do not sit pretty on balance sheets. In countries like the U.K., where the insurance industry is heavily regulated by the Financial Conduct Authority (FCA), the 'Treating Customers Fairly' principle demands that the insurer continues to administer the product even if just one customer remains.

In this article, we detail the key challenges of closed books in the U.K. insurance market and the options that insurers have to deflect the negative impact of such policies.

IT Hurdles

The biggest issue in administering legacy books is IT. As many of these policies are written on legacy platforms, the cost of maintaining these systems to keep them working and compliant with regulations rises every year. At the same time, there's an increasing shortage of resources who have the knowledge and skills to maintain these systems.

Thus, the IT servicing part alone for closed books is a costly proposition for insurance companies. Right from processing and IT support costs, to policy reviews and eligibility, to generating statements and payouts, closed books become a burden. Additionally, the organic growth (through acquisitions) of core IT that runs the processes brings in complex, fragmented and outdated applications that consume up to 75 percent of IT operating costs. Implementing process automation, platform consolidation and data standardization is both daunting and expensive for insurers.

Administrative Roadblocks

The cost of administration of legacy books is also a key challenge for insurers. Run-offs reduce the number of customers paying premiums with each passing year. The resulting increase in 'per policy' administration and operational costs places tremendous pressure on profitability.

As closed book pension schemes are often clubbed with other investment instruments such as bonds, property and shares, the profits are collectively shared across these 'with-profit' funds. The performance of these funds [despite the recent spike in the U.K.'s Financial Times Stock Exchange 100 Index (FTSE)] depends heavily on the underlying investment routes which have been at a historical low in recent years. As a result, the values for some funds have eroded by more than 25 percent in the past six years, putting further pressure on policy management costs.

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Agility Constraints

As a practice, when such blocks of products are closed for selling, insurers adopt a strategy of investing less in riskier asset classes (shares) and relying more on safe assets such as gilts. The objective is to protect capital. The downside of such a strategy is that the funds' ability to perform is restricted by virtue of lesser risk. For example, a leading U.K. insurer reduced the proportion it invests in shares from 41 percent to 10 percent when it closed its pension fund, thereby significantly reducing the possibility of higher returns.

Against this background, and keeping in mind the return on investment, it is not surprising that insurers are reluctant to invest in new technology to operate closed books.

As closed block products are tied to different legacy systems, there's high dependence on manual efforts since the systems lack the capability and agility to react to frequent regulatory changes quickly. Hence, unlike in open books where insurers can leverage new, flexible and contemporary systems, they have to look for other means to safeguard profitability. They may charge a higher annual maintenance fee of say 4 percent (against the standard maintenance charge of 1 percent for new products) or introduce higher exit loads (insurers on some schemes charge as high as 10 - 15 percent of the fund value as exit penalties).

This has led to insurers coming under the scanner of the FCA due to concerns that closed book customers were not being given the same treatment as open book customers. Such pressure has compelled some companies to cap the early exit penalty at 5 percent.

Course of Action

Insurers have three options before them to avert any kind of losses due to closed books.

The migration option from one legacy system to another (closed book to open) poses a huge challenge. Integration is difficult and manual steps do not scale up to requirements. When the entire block is closed, it's closed for all products such as bonds, pensions, protections and life as well. This can be tricky as new and uniform procedures have to be re-written so that the new platform is suitable for all the products. Seamless migration is critical as the policies are still live and active on the systems, and will keep generating business as usual volumes.

Buying and selling closed books is a second option that is common in the U.K. insurance industry. Insurers such as Reassure, Phoenix and Guardian are prominent buyers and consolidators of blocks of in-force life and pension insurance business. Before buying such blocks, the buyer introduces risk contingencies, migration costs, and profit and loss projections into the price. This could make it an unviable proposition for the seller. Furthermore, the seller could lose out on the opportunity to cross-sell to these policyholders. This could impact the seller's revenue and brand reputation in the event of a poor cultural fit.

A third option is in establishing specialist services in closed books through consolidation or outsourcing. The U.K. is a good example of a large and mature closed book market. The adverse market conditions of the early 2000s led to a number of life companies closing part or all of their books to new business. Some companies have created a closed book block and manage it separately even as they continue to sell new products.

A number of closed books were up for sale because of which the industry saw the emergence of closed book consolidators. Today, almost all leading U.K. insurers have closed books. Excluding closed occupational pension schemes, the approximate aggregate market size for closed books currently stands at about 70 million policies.

Insurance companies have also achieved significant benefits by outsourcing their closed books to third parties. Third-party providers manage the portfolio and all its support systems (IT assets, infrastructure, contact centers), and achieve economies of scale by simultaneously servicing multiple clients to spread their costs over larger volumes.

Such providers also bring their expertise and experience in IT integration and process design for greater efficiencies at significantly reduced costs. Enhanced service improves customer engagement on such portfolios, and provides better quality of data, clear records and documentation.

Closed book outsourcing can enable insurers to become more agile in a dynamic and competitive business landscape. It releases them from the tedious and costly management of an unavoidable, but slow-growth business, and allows them to focus on new high-return opportunities. In doing so, they can vastly improve customer experience, and lower capital requirements and expenditure.

Third-party providers handling closed books enable insurers to focus on their core businesses

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