

14<sup>TH</sup> EDITION

# INSURANCE INSIGHTS

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## INTRODUCTION

Welcome to the 14th Edition of our EMEA Insurance Insights, rounding up a number of the themes that are top of our clients' agendas.

I am delighted to present our 'Executive Conversation' interview with Tom Stoddard, CFO of Aviva. Tom shares with us his outlook on the global insurance sector, Aviva's focus on specific markets, such as Poland in Eastern Europe and China in Asia, where they anticipate high growth over the next few years. Aviva is going through a transformation journey and their priorities are clear, to build on their distinct competitive advantage and grow shareholder dividends. We also get an insight into Tom's personal leadership style and what he does to relax outside of work.

In this edition, we have a broad spectrum of the latest topics and trends across the European insurance industry. This ranges from the ongoing regulatory reform, how to achieve business optimization with the arrival of Solvency II, to the impact of digital on insurers in this new world of digitalisation.

I am also very pleased to share the launch of our Insurance Webinar series. We had the pleasure to host the first webinar with Tom Wilson, Group CRO of Allianz. Tom discussed in depth how firms should manage value and capital, against the backdrop of his recently published book, Value and Capital Management. You can watch the replay of the webinar via our Executive Conversations webpage.



Erik Stattin

A handwritten signature in black ink that reads "Erik Stattin".

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# A CONVERSATION WITH TOM STODDARD

CFO, AVIVA

Interview conducted by Jan-Hendrik Erasmus, Head of UK Insurance Practice, Oliver Wyman



OLIVER WYMAN: *Tom, thank you for taking the time to speak with us today. What is your view on the global insurance sector, perhaps with a specific focus on Europe and Asia?*

TOM STODDARD: At Aviva, we tend to focus on specific markets instead of regions. We try not to generalise as there might be specific value pockets within markets which we'd like to leverage. We continue to be positive about and see growth in Asia, especially in the Chinese market. Poland is a great example of a high growth market within Eastern Europe where we expect to see continued growth.

The challenges that we see are more macro-economic in nature. The persistence of low interest rates is concerning for us and we hope to see regulators and national banks look to examine their strategies in this regard.

OLIVER WYMAN: *Where do you think the competitive advantage for the insurance industry will come from in the future and what do you see as the main growth areas?*

TOM STODDARD: We believe that any competitive advantage is going to arise from meeting customer needs. It's tough to run a risk business in today's business environment and we think the way to succeed is by placing customer needs first, in line with Aviva's "True Customer Composite" strategy that we've discussed before. This means that we can meet all customer life, general and health insurance and asset management needs. Many customers may not make their final decision via a digital platform but they will do the majority of their research in that way. Focusing on digital means that we can lower cost and that means we can take the time to invest in better customer interactions. For us it offers the ultimate in transparency in the customer journey – for both Aviva and our customers.

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We see our digital channels as a strategic anchor at Aviva and will continue to invest in this capability.  
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For Aviva specifically we believe that, in addition to a strong customer focus, competitive advantage will come from focussing on specific markets, segments and products that drive value for ourselves and our customers. We see our digital channels as a strategic anchor at Aviva and will continue to invest in this capability.

*OLIVER WYMAN: The acquisition of Friends Life closed earlier this year, how does the integration of this business strengthen your life business and the Group as a whole?*

**TOM STODDARD:** At Aviva, we consider ourselves as the British champion. The acquisition is a fantastic opportunity for us to leverage our respective strengths. Bringing Friends Life into the Aviva family will deliver increased liquidity and cash flow to Aviva. And for Friends Life this meant that we could leverage Aviva's ability to build businesses. The acquisition has enlarged our UK capital base which gives us the opportunity to invest in growth and be flexible in a way that was not possible previously.

*OLIVER WYMAN: In your most recent results presentation you highlighted the turnaround of Aviva's financial position over the last three years. I think it's fair to say the transformation is currently ahead of schedule. Given where you are today, what are your priorities for the next three years?*

**TOM STODDARD:** Whilst we're ahead of schedule we're still in the middle of a transformation story. Aviva has been around for the last 319 years and we want to make sure that it is here for another 319 years. Our challenges over the next three years will continue to be around realising the Friends Life synergies and to invest and develop our capabilities around the True Customer Composite and Digital First.

Alongside the integration of Friends Life, we are shifting our focus to specific markets looking at ways that we can drive growth within those particular geographies. We are not interested in being "everywhere". We want to focus on markets where we have a distinct competitive advantage and can leverage those advantages to grow shareholder dividends.

*OLIVER WYMAN: Changing track a bit, how would you describe your personal leadership style, and do you think it has evolved over time?*

**TOM STODDARD:** Well, I was an investment banker for many years working very long hours. And now I'm a financial services executive still working very long hours! My leadership style has evolved in as much that I like to focus on solving problems, but I'm still trying my best to cut through the noise. There can be some things that barely move the needle that take up a lot of time and I try my best to identify them and move on without getting distracted.

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OLIVER WYMAN: *The demands on senior management of a large, multinational financial institution are ever growing. Outside of the very long hours, how do you relax and get away from it all?*

TOM STODDARD: There are two things that I love – soccer or proper English football as it should be called and fly fishing. I believe that it is incredibly important that we safeguard the environment for future generations. I work with a fantastic charity in the U.S called Trout Unlimited that is dedicated to conserving, protecting and restoring North America’s coldwater fisheries and their watersheds. When I am out in countryside focussing on casting the fly, there are many things to think about and none of these involve work. That is when I truly switch off and relax.

OLIVER WYMAN: *Having previously worked in investment banking and corporate advisory, what excites you about working in the insurance industry?*

TOM STODDARD: Lots of things! Firstly, it’s a very complicated industry which I like. I think that makes it a challenging place to work. But those challenges offer huge opportunities. At Aviva, we have spent quite a bit of time looking at the big picture and things such as which products to take to which markets. Part of my focus is now on the internal finance function and making sure that’s running as efficiently as possible to help us drive value and growth. Looking at what we measure and how we measure success will help us do that.

OLIVER WYMAN: *Thank you Tom, for taking the time to speak with us.*

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# BUSINESS OPTIMIZATION HEADING INTO SOLVENCY II

On 1st January 2016, the Solvency II regulatory regime will become mandatory for all European insurance companies, concluding the process that had begun back in 2003.

The primary objective is to improve the level of protection afforded to policyholders by linking regulatory capital requirements more closely to the underlying risks insurers are exposed to. For example, insurers with a higher proportion of risky assets will need to hold a higher amount of regulatory capital than insurers investing very conservatively. This ties into a secondary but equally important objective namely to create a level playing field for insurance businesses across Europe.

## SIGNIFICANT CHALLENGES AND OPPORTUNITIES REMAIN FOR INSURERS

Whether or not the final Solvency II rules, and the way in which national regulators choose to interpret them, fully achieve these objectives is a matter for debate. What is clear, however, is that the calculation approach followed by insurers does vary – for example, in whether to use an internal model or a standard formula, or whether to apply the matching adjustment or volatility adjustment or transitional measures.

On the whole, these differences are probably not well understood by the investor and analyst community and detailed disclosures from insurers have been sparse. To date it has been difficult to focus on anything other than the headline solvency ratios. Consequently, the industry faces both communication challenges and pressure to improve their solvency position, regardless of the calculation approach used. At the same time, it is clear to the investor and analyst community that Solvency II and its mark-to-market valuation approach and risk-based capital assessment should trigger changes to the business model across the industry. We observe significant interest among this community to see how individual insurers are adapting their business and processes in response to Solvency II.

Perhaps the most significant difference in approach between firms is the use of an internal model or partial internal model as opposed to the standard formula prescribed in the Solvency II text. In our experience, there is significant balance sheet and business optimization potential in response to Solvency II for both types of firms.

For many internal model (or partial internal model) insurers, the focus over the last 36 months has been model building, model calibration and the internal model application process. This has required intensive regulatory dialogue and significant effort to meet not only the requirements outlined in the Solvency II text, but also to address the points raised in these discussions.

Given both the challenge of getting the model 'over the line' and the challenging business environment of recent years (low interest rates, renewed conduct focus, etc.) it is perhaps not surprising that many insurers have been unable to dedicate significant time to considering what their business should look like under Solvency II.

This is both a challenge and an opportunity: in most cases, significant improvements to how the business is run in a Solvency II world could still be made through changes in the balance sheet or in various aspects of the business model, like ALM and investments, product design or management actions in adverse scenarios. The typical benefits are increases in the solvency ratio, improvements in the underlying stability of the solvency ratio and an increased awareness around how and where future profits and cashflow will arise under Solvency II.

For standard formula companies, preparation of the modelling tools has been comparatively more straightforward. However, there have been some regulatory challenges over the appropriateness of their results and the calculation approach. The challenges faced by many firms using the standard formula centre on the absolute level of solvency calculated with this simplified approach, and the potential volatility in this number over time.

This can be seen from available industry-wide data (relating to the European Insurance and Occupational Pensions Authority (EIOPA) stress test performed during 2014). The smaller companies (i.e. those more likely to be using the standard formula) making up the core sample showed a solvency ratio lower than 150% in almost half the cases (and lower than 100% in 15% of the cases.)<sup>1</sup>

## PROVEN AND TANGIBLE RESULTS FROM BUSINESS OPTIMIZATION PROGRAMS

Both standard formula and internal model firms can benefit from a renewed focus on optimizing the business and the balance sheet for capital and stability heading into Solvency II. We have completed more than a dozen balance sheet, capital and business optimization programs for our clients throughout Europe and the UK and covering both internal model and standard formula firms. In all cases viable capital and stability levers have been identified with the average increase being around 15 percentage points of solvency ratio within nine months, together with stability benefits. If and where identified, quick wins are often realised in a matter of weeks.

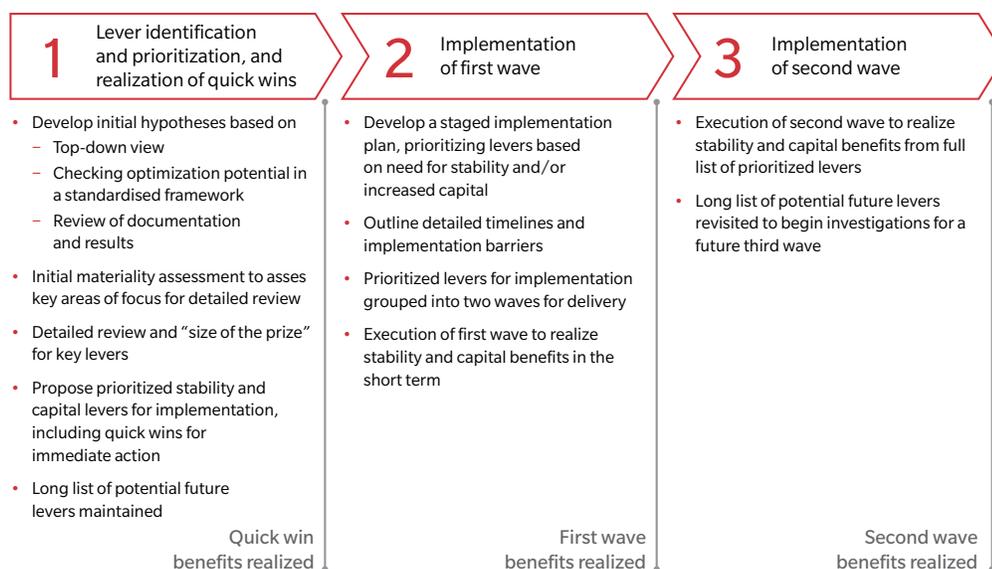
<sup>1</sup> EIOPA Insurance stress test 2014, 28 November 2014). Reference data are shown on page 7 : "unweighted distribution of pre-stress SCR ratios"

We have developed a standardized approach for such projects that has allowed us to identify the key levers quickly and exhaustively. A methodical process following a structured framework and assessing a comprehensive set of levers greatly aids prioritization and several of our clients have now completed benefit delivery programs in advance of Solvency II arriving. The philosophy is to identify and develop measures that have a lasting and positive impact on the risk profile, balance sheet and regulatory solvency position (including on its volatility over time).

For insurers looking to initiate their own balance sheet and capital optimization program we would recommend dividing this into three main stages. Programs can typically be completed over a period of six to seven months, with benefits realised throughout this process. The stages for such a program are outlined below:

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**Exhibit 1: Suggested structure for balance sheet and capital optimization programs**



At the start of any work we would recommend an initial triage to quickly narrow down the focus to those areas with greatest potential.

The first step involves the identification and prioritization of levers suitable for optimizing the balance sheet and business models of the insurer, taking into consideration the expected benefits to the firm. The work is usually completed top-down with a focus on the most material areas, checking optimization potential of levers in a structured framework, making use of external benchmarks (where available) and a review of documentation and the latest results. The process includes identifying the potential impact across different optimization levers, and prioritising these for implementation, including any quick wins that can be put into practice with comparatively little effort and cost. Figure 2 below provides an example of the types of levers and underlying actions insurers we have worked with have implemented but is by no means exhaustive.

## EXHIBIT 2: EXAMPLE LEVERS FOR CONSIDERATION

LEVER	DESCRIPTION	POTENTIAL SOLEVENCY IMPACTS	TYPICAL STRENGTH FOR VOLATILITY MANAGEMENT
<b>Solvency II calculation approach</b>	Use of (partial) internal models for relevant parts of the business, and potential use of matching adjustment, volatility adjustment or transitional measures where appropriate	Reduces SCR and increases own funds	Medium
	Optimizing base balance sheet calculation, e.g. removing prudence from best estimate assumptions	Increases own funds	Weak
	Ensuring stresses are appropriately calibrated and assets exposures are shocked correctly, i.e. not too conservatively	Reduces SCR	Weak
<b>Management actions</b>	Embedding management actions in models can improve solvency but can also reduce management discretion, e.g. contingent actions under stress	Reduces SCR and increases own funds	Strong
<b>ALM and investment strategy</b>	Investment portfolio optimization for Solvency II, e.g. hedging strategies to reduce market risk SCR	Reduces SCR	Strong
<b>Balance sheet structure</b>	Range of potential actions to improve solvency, e.g. changes to legal entity structure, changes in capital structure, reinsurance, etc.	Reduces SCR and increases own funds	Medium
<b>Product optimization</b>	Capital efficient product design, including review and re-design of existing products where appropriate, e.g. restructure fees on in	Reduces SCR and increases own funds	Strong, but takes time to replace business

During the second step, the first wave of prioritized levers is implemented to achieve stability and capital benefits in the short term. Detailed implementation plans for all levers are developed, with implementation scheduled for multiple stages or waves based on the relative benefit and complexity of the levers.

In the third step, the remaining, more complex optimization levers are implemented. This often requires the joint effort of different functions within the insurer, such as Risk, Finance, Actuarial, Asset Management and/or IT. Some insurers use this phase to revisit the lower priority items from step one, and investigate additional future areas of optimization.

## CONCLUSION

Solvency II is virtually here and a significant number of companies will face challenges relating to the level of their solvency ratio and its volatility over time. In particular, in the face of analysts or investors focusing on headline numbers and want to understand how business models are adapted for Solvency II.

Oliver Wyman has developed and successfully implemented a proprietary approach to reviewing and optimizing insurer balance sheets and capital under Solvency II, addressing a comprehensive set of levers in a structured framework. The approach focuses on capital and stability levers and allows management to prioritise heading into 2016.

**AUTHORS:** Jan-Hendrik Erasmus, Head of UK Insurance Practice | Astrid Jaekel, Partner | Chris Leach, Principal

# IT'S TIME TO THINK DIGITAL

Like intelligence agencies, insurers need fewer James Bonds and more computer nerds

If you take the movies seriously, spies have exciting jobs. To get the low-down on their suspects – Cold War communist double agents, power-mad dictators and the like – they sneak into offices at night to photograph documents with miniature cameras, observe underwater lairs from mini-submarines, and tease loose pillow-talk from the beautiful girlfriends of cruel warlords.

Alas (for the movies), these hands-on “intelligence gathering” techniques are becoming obsolete. The explosion of data provided by the Internet, mobile phones, and global positioning systems has radically changed the sources of information that intelligence agencies rely on.

When documents are stored on computers linked to the Web, there is no need to rummage through filing cabinets. A little hacking will do. When people show you where they have been by posting photos on Facebook, and when you can track the locations of their mobile phones, you don't need to follow them around.

As a result, intelligence agencies need fewer exploding cigars and more mainframe capacity. Fewer James Bonds and more computer nerds.

Unlikely as the comparison may seem, the insurance industry is undergoing the same transformation.

Like spies, insurers seek to make informed estimates about things that are normally hidden – not espionage or Cold War battle plans, but the probabilities of insurable events: car accidents, ill health, living to 95 years of age, being burgled, and so on. And just like spies, insurers are finding that new information technology is making many of their traditional methods of discovery redundant.

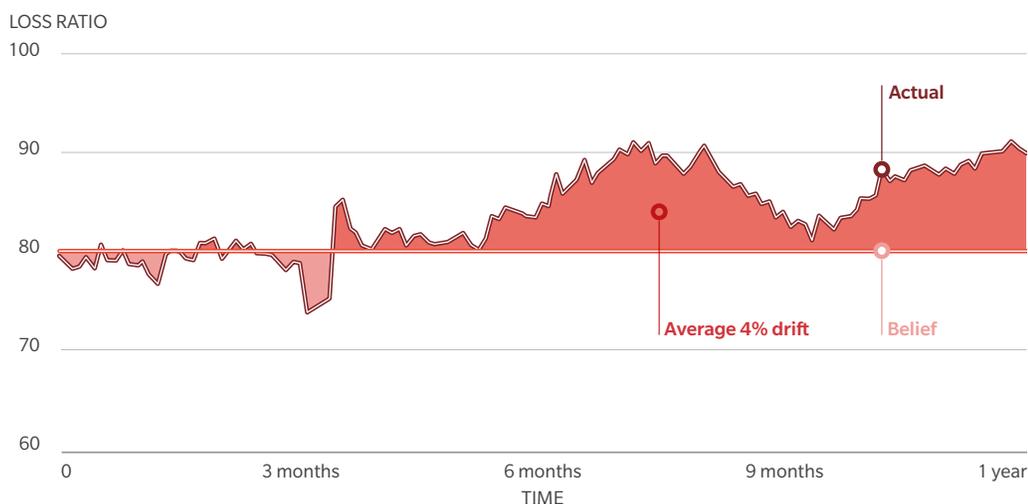
Consider car insurance. Statistics about the age, sex, and marital status of claimants has allowed actuaries to work out that single 20-year-old men typically drive more dangerously than 40-year-old married women. But, of course, this is a generalization. Some 40-year-old women are wild behind the wheel, and some 20-year-old men are highly conservative.

That should be obvious to anyone aware of the difference between group averages and individual outcomes. But the point will be made even more obvious in the future by “telematics,” technology that allows insurers to observe the actual driving behavior of policyholders. The controversy sparked by the 2012 EU ban on using gender as a factor in car insurance will soon look almost quaint. When insurers can observe driving habits directly, crude generalizations using gender-based predictions will be obsolete.

Telematics is but one example. Customers' activities are increasingly recorded electronically: what we buy from whom, where we dine out, whether we pay our debts, where we are interested in going on holiday, which articles we read in which newspapers, which movies we watch. Such information can paint an extraordinarily accurate picture of a person, her lifestyle and disposition, making the old socio-demographic but impersonal information that actuaries have relied on seem archaic.

### Exhibit 3: New Business scored Loss ratio

In digital markets, the quality of loss models deteriorates fast – by as much as four loss ratio points per year



Source: Oliver Wyman analysis.

Note: “Belief” is the predicted loss ratio for a tranche of new business at time period X. “Actual” is the eventual actual loss ratio for the given tranche of business.

Just as intelligence agencies today sort nuggets of valuable information from ever increasing torrents of data, insurers will similarly need to sift through huge and varied quantities of data to discover relevant behavioral insights – and they will need to make agile decisions as a result.

This is not just a theoretical, future problem. In markets such as the United Kingdom, increasing flows of information and rapid “aggregator-based” trading are already the norm in motor insurance. Our data suggests insurers who cannot adapt their models fast enough could lose out by as much as four percentage points of margin per year.

Of course, not all this information will be available to insurers. But much of it will be, if only because low-risk people will benefit by making it available. Openness will be rewarded with lower premiums.

In this context, the historical insurance business model looks increasingly dinosaur-like. New commercial species – brand-led consumer-oriented companies and “information companies” such as Google, which were not merely born into this new environment but helped to create it – are better positioned to capture new opportunities. They have the right skills and cultures, and they are unencumbered by legacy assets devalued by the explosion of information and the growing willingness of people to transact online.

You only live twice, according to the title of a James Bond movie. If today’s insurers are to thrive in the new world of abundant information and hands-off transactions, they will need to be reborn. They must transform into the very information companies that threaten to supersede them.



For this idea at length visit

<http://www.oliverwyman.com/insights/publications/2015/jun/think-digital.html>

**AUTHOR:** Arthur White, Partner, Financial Services

# CLEAR SAILING FOR COMMERCIAL P&C DISTRIBUTION?

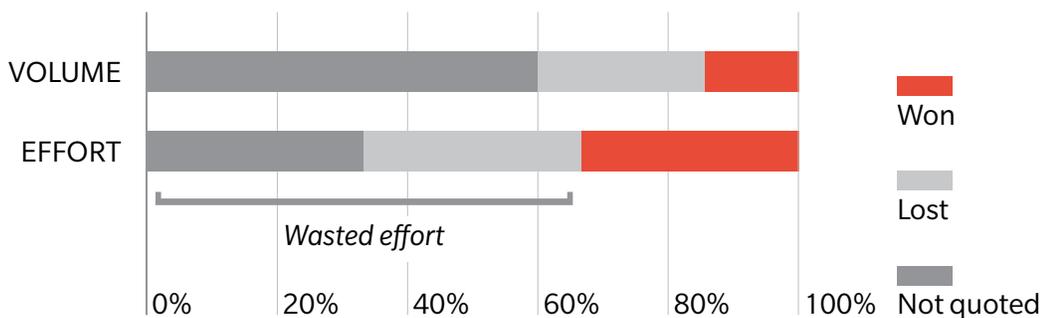
In just a few years, the market will be transformed by a new level of transparency. Advice for forward-looking companies: Don't wait

In the great race to incorporate digital data and analytics into business decisions, the commercial property and casualty insurance industry, after a slow start, has been catching up with leaders like electronic commerce giants and supermarket chains.

Property and casualty insurance sold to corporations is a business that relies a great deal on established "trading routes", with each bound policy representing a successful "journey" between a "supplier" and a "consumer". No individual underwriter, no matter how experienced, can possibly know every broker, and no one has complete information on the flow of protection needs across clients. Even insurers dominant in a specific line of business only see a small portion of submissions being placed through an intermediary – 10 or 15 percent, even when the insurer and the broker have a strong, established relationship. Therefore, no one player has an accurate, up-to-date "master map" of the entire market, hence limiting transparency into the market size, opportunities, and carriers' risk appetites. Why is P&C so dependent on experiential knowledge and relationships? For many players, there have been few practical alternatives.

The consequence: Insurers waste enormous amounts of time pursuing business they will not get, and may not even really want. Brokers rely heavily today on deep individual (or team) experiences to identify the best potential markets for the risk. Ultimately, insurers find it difficult to navigate the market; and to truly deploy a strategic framework for growing their business and deploying their capital.

Exhibit 4: Insurer's pipeline: win 15 percent of submissions and waste 66 percent of the effort



Source: Oliver Wyman Analysis

## WHY TRANSPARENCY MATTERS

We are on the verge of a much better way. Within this decade, new sources of data will come together with advanced analytics to bring a new level of transparency to commercial insurance.

Transparency will influence all insurance activities, profoundly changing the behavior of buyers and sellers alike. The process of change is well under way: data is already used to better describe exposures, measure underlying risks, price policies, and later triage claims based on predictive analysis. Risk managers have embraced analytics as a large component of their decision making process and expect it in the value proposition of any service they receive. Examples range from product benchmarking studies as part of insurance purchase to sophisticated risk modeling exercises that determine optimal coverage parameters. Brokers are codifying pipelines in order to institutionalize their market knowledge and further improve how they serve clients. Large carriers are investing in data and analytics groups to help them improve underwriting decisions, pricing, marketing, and product innovation.

Distribution is a bit behind, but is catching up. While we do not expect all commercial insurance policies to trade like financial instruments on a Bloomberg terminal – the complexity and heterogeneity of risk will likely preclude this from happening – we do believe that the commercial insurance marketplace is poised for a revolution in the next few years.

In part, this change is being driven by a pair of recent developments:

**A** The workflow of the insurance industry is now largely digital, enabling the creation of valuable historical databases.

**B** Retail and wholesale brokers are increasingly willing to share their placement data, including exposures and company details.

These databases are not the map that the industry needs, but they are a significant step in the right direction.

In this new world, there will be far reaching consequences for both large established carriers and specialists that play in niche markets. For established insurers size might not be as much of an advantage as new competitors are added to the map and brokers increase their sophistication for sourcing the best risk-bearing capacity. Smaller specialists will continue to innovate in order to grow and deliver on broader risk appetites. The new map of the world will take some time to draw in detail. But that is not an argument to wait. The period of transition, when transparency is available only to companies that are willing to work for it, will be a time when aggressive players can seize competitive advantage – when long-term winners and losers will be determined.

### DIGITIZATION EFFORTS:

#### LARGE BROKERS

- Company information
- Exposure details
- Pricing trends
- Coverage needs
- Risk profile

#### INSURERS

- Historical submissions
- Prior loss runs
- Policy holder data
- Claims data
- Risk engineering reports

#### THIRD PARTY

- Aggregation of small broker pipelines
- Flood data
- Premium estimates
- Rate filings and state bureaus
- Building construction reports

Marsh, for instance, offers MarketConnect, an online portal that provides carriers with an ability to search Marsh's upcoming renewals and hence improve their prospecting capabilities. It provides a view into their performance with Marsh and also competitive insights for carriers, e.g. benchmarking against peer ratios. Other large brokers have developed similar systems and independent technology firms are working to aggregate information from smaller brokers to create a portion of the map.

Note: The information in this report was produced by Oliver Wyman. Marsh and Oliver Wyman are wholly owned subsidiaries of Marsh and McLennan Companies.

## BENEFITS OF BUILDING A MAP

Let us be clear: The goal companies should be pursuing is not simply to acquire data or analytics capabilities. It is not just a matter of changing what your company knows – but of changing how your company and the people within it do business. It is not a data science project; it is not an IT project, though it will certainly involve IT. These efforts need to be seen as a transformative strategic project being undertaken to capitalize on a relatively small window of opportunity.

The steps involved are resource-intensive but straightforward:

- 1 Build the map.** You will need to stitch together various datasets – broker pipelines, historical submissions, historical loss runs, internal claims data, risk engineering reports and third party data sources such as risk manager surveys, regulatory filings and state bureaus. While some of this data is already available in digital formats, a large portion of the data needs to be extracted from paper applications, excel files and emails. The ideal map will account for every single insurable risk, highlight profit pools and will refresh dynamically as new information flows in.
- 2 Develop analytics and tools.** In addition to building a map, carriers will need to invent new ways to use the data and guide underwriters and distribution activities. For example, sophisticated carriers can develop tools to predict the likelihood of a quote turning into a bound policy. Such approaches, applied in conjunction with disciplined underwriting and pricing, will allow those carriers to quickly identify, and proactively seek, risks where they have a competitive advantage vis à vis the market. Again, though there are components available to assist in this process, substantial in-house or outsourced development will be necessary.
- 3 Manage the change to a new way of working.** This step must not be underestimated. The workflows and work habits of underwriters are deeply ingrained. For many companies that decide to pursue a transparency strategy, changing those habits will be the most challenging part of the process.

And what does the insurer get in return for this investment? Benefits will come primarily in three areas, some easier to achieve, and with lower investment, others requiring the full transformation. In ascending order of difficulty, they are:

- Better strategic planning and target setting
- Efficient routing of business
- Nimbleness

Exhibit 5: Distribution using the map

DATA

**DATA FEEDS**  
E.G. LARGE BROKERS AND  
THIRD PARTIES



**CARRIER DATABASES**  
E.G. CLAIMS AND POLICY  
ADMINISTRATION SYSTEMS



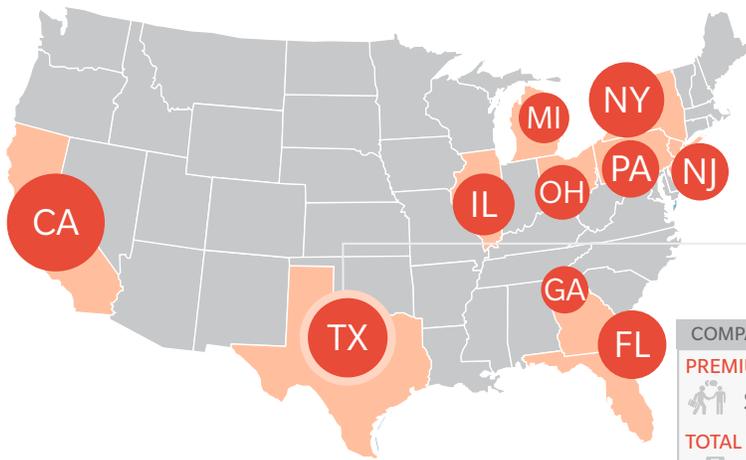
**UNSTRUCTURED DATA**  
E.G. STATEMENT OF VALUES



MAP OF INSURABLE RISKS

**KEY STATISTICS**

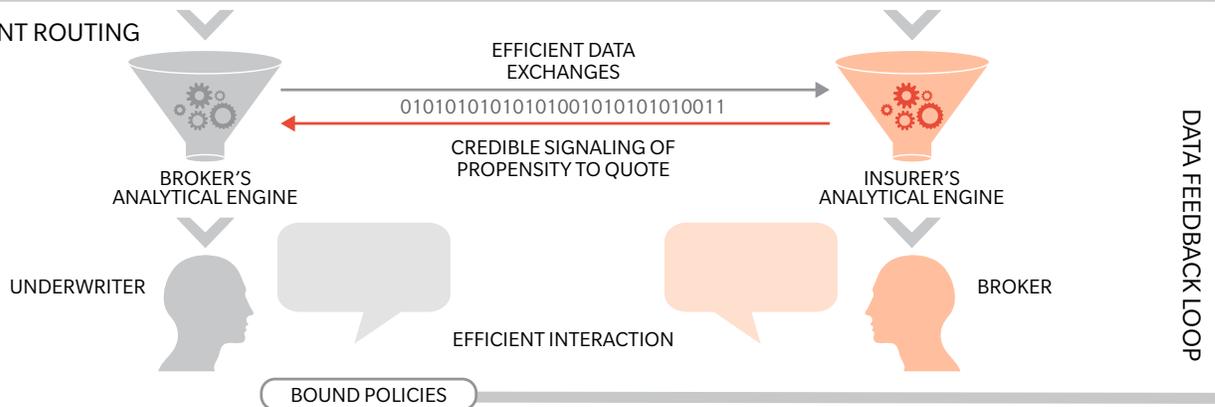
- \$270 BN IN ANNUAL PREMIUM<sup>1</sup>
- 102 K COMPANIES WITH OVER 100 EMPLOYEES<sup>2</sup>
- 1.1 MM COMPANIES WITH 10-100 EMPLOYEES<sup>2</sup>



**TEXAS**  
INDUSTRY: ENERGY  
SIZE: LARGE  
PRODUCT: PROPERTY

COMPANY 1			
PREMIUM	REVENUE	PAYROLL	HEADCOUNT
\$	\$ BN	\$ MM	#
TOTAL INSURED VALUE \$ BN	RENEWAL DATE DD/MM/YY	BROKER	

EFFICIENT ROUTING



1. Best's Aggregates & Averages, A.M. Best Company, 2014 Edition  
2. US Census Bureau (2012)

**Better strategic planning and target setting:** As larger portions of the map of insurable risks become transparent it will be easier for insurers to identify where the attractive pools of business are, develop winning products and services and set targets. The benefit is straightforward – insurers will be able to formulate more effective strategies, communicate clearly and consistently their risk appetite, allocate resources against the most valuable opportunities and be able to measure performance in an objective manner.

Because strategic planning of this sort requires relatively little in the way of change management and the most straightforward analysis of data – market size, opportunities, potential profitability – companies can begin taking advantage of it as soon as the map is assembled.

**Efficient routing of business:** As insurers gain the ability to access the collective knowledge and past behavior of every underwriter (and their broking partners) they will be able to achieve new levels of efficiency in routing new policies by matching the needs of a customer to the skills of a specific underwriter. We believe carriers will be more proactive and assign each prospect with a probability score, signifying its likelihood of binding profitably and thus (re)prioritizing the pipeline to focus its underwriters and distribution partners on the highest value clients and policies. Carriers that are successful at embedding analytics into the day-to-day workflows of their underwriters will be able to improve their efficiency dramatically. We believe that as much as 50 percent of the effort that is spent on submissions that eventually will not bind (i.e. wastage) can be avoided by carefully screening upfront.

Efficient routing is not just a technical challenge. It also involves getting underwriters to accept a new way of working, with far more corporate oversight over where they look for business and which opportunities they pursue. Our experience in related projects tells us that the transition is not always easy. In addition, efficient routing requires looking beyond internal processes and developing new ways of communicating messages about your capabilities, interests, and risk appetite with an evolving set of counter parties.

**Nimbleness.** Nimbleness, in a way, is the payoff for developing the ability to identify a high-value pipeline of opportunities through strategic planning and a system for guaranteeing that underwriters are in fact proactively pursuing those opportunities. Once you have created the feedback loop of predicting which activities will be profitable, then assessing which ones actually were, you are well positioned to respond quickly to changes in the marketplace, pursuing opportunity wherever it leads you, constantly reassessing your strategy and execution in light of the latest information.

Nimbleness is built upon efficiency, but it is a different capability. Where efficiency enables you to do your traditional job more quickly, with fewer steps, and at lower cost, nimbleness is about changing from your traditional job or market to a new one as situations change. Becoming nimble is the highest, most valuable use of a “map of the world.” For companies that are up to the challenge, it will be a transformative event.

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*Identification of profit pools will enable optimal allocation of capital and resources.*

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*Efficient routing using scoring algorithms and the map is estimated to double underwriter productivity.*

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*In the new world, insurers can choose to enter/exit markets to chase profitable business instead of sticking with loss-making accounts through soft cycles.*

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## DESTINATION: TOMORROW

In a few years, the new map of property and casualty will be filled in and widely available. It will have an enormous impact on how insurance is bought and sold. In the newly transparent market, competitive advantage will go not to the company that has the map – everyone eventually will – but rather to those that understand how to use it and have adapted their business strategies and processes to succeed.

Transparency will shake up the hierarchy of the industry. Scale will be less important, and numerous players will seize opportunities to disrupt traditional arrangements and relationships. Chief among them, we expect, will be the companies that over the next year or two bootstrap themselves into the new world by creating and beginning to use their own map. The sea captains of old may have stuck to familiar routes, but even they understood: the whole point of having a map is letting you go someplace new.

### NEW PLAYERS, NEW ARRANGEMENTS

Transparency leads to another form of nimbleness as well. New types of suppliers are being “added to the map,” and thus providing additional capacity and increasing competition, particularly insurance “start-ups” and capital markets instruments. The insurance start-ups of the early 2000s have matured over the past decade and are now valid options to an ever-larger set of commercial clients, with broader product suites serving a wider geographic area. As these insurers continue to function in a nimble and lean fashion, we believe they will continue to provide pricing competition to traditional carriers in the lines they operate in. On the capital markets side, change may not be immediately obvious given insurance linked securities, such as catastrophe bonds, have been in the market for some time now. What we think will be different is the extent to which capital markets will be able to penetrate the insurance market.

We also believe that transparency will support the trend of increased use of “pre-arranged risk pools” – broker facilities, quota shares and exclusive broker-carrier agreements. The underlying dynamics of such arrangements are attractive to insurers as the flow of transactions is more predictable and its underwriting easier. A more transparent and fluid market is bound to keep alternative capital sources interested and willing to join new arrangements.

For example Nephila Capital, the largest insurance linked asset manager, has recently entered into an arrangement with AmWINS<sup>1</sup>, a large wholesaler, to take a 10% share of all property policies transacted through the brokerage. In doing so Nephila has succeeded in bringing alternative capital directly to the primary brokerage/insurance market, which is a novelty and also a model many investors can follow.

1 Insurance Insider. Robertson, F. and Bull, D. (2015, March 5). “Nephila to ramp up insurance book with Amwins facility”.

*For more please visit <http://www.oliverwyman.com/insights/publications/2015/jul/pc-distribution.html>*

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# WHOSE LINE IS IT ANYWAY?

## Defending the Three Lines of Defence

### *“How do you organise a financial services firm to manage risk effectively?”*

This question is seldom answered without the conversation turning to the “Three Lines of Defence” framework. Yet this ubiquitous model receives only lukewarm support from those who use it.

In this short note, we argue that there’s a self-fulfilling prophecy being played out in the tepid attitude of users. Institutions are “adopting” the Three Lines of Defence in a half-hearted way and are accordingly reaping half-baked risk-management outcomes.

We believe that the philosophical foundations of the model are sound, but that it will only deliver effective risk management when coupled with a specificity and thoroughness in implementing it that has largely been absent from the industry to date. The challenge for C-Suite executives and board members is to diagnose whether their organisations are truly “walking the walk” or merely “talking the talk.”

Ambiguity on this topic is dangerous. Putting aside the matter of inefficiency, without a healthy functioning risk-management framework in place, firms can be exposed to risks being taken by a small number of people with asymmetric incentives to the detriment of the business, the customers and the industry. Add to this a false sense of security being provided to the board and supervisors on the comprehensiveness of independent and expert challenge and you have a precarious state of affairs.

# THE SELF-FULFILLING PROPHECY

In the summer of 2013, the Parliamentary Committee on Banking Standards published their report, and devoted two pages to lambasting British Financial Services firms' reliance on "The Maginot Lines of Defence."<sup>1</sup> Their criticisms were that a concept of unknown provenance had led to endless rounds of simply ticking the boxes and very little real management of risks. Too many accountants, not enough accountability.

In Q4 2014, the Office of the Comptroller of the Currency (OCC) published its "heightened standards" guidelines<sup>2</sup> on risk governance, including an attempt to redraw the Three Lines of Defence that would have the banking industry engage properly with the model. Shortly after, the Basel Committee on Banking Supervision (BCBS) reminded the banking industry<sup>3</sup> that risk governance frameworks "should include well-defined organisational responsibilities for risk management, typically referred to as the three lines of defence." The model is here to stay, at least for the foreseeable future.

And yet, in our experience across banking, insurance and asset management, this is a pervasive but unloved model. Clients consistently "adopt" the Three Lines of Defence model, but few place real confidence in it, few have anchored their risk management philosophy to this concept at a genuinely practical level, and few senior managers are prepared to put their faith in it when it's their livelihood that's on the line.

We believe, however, that reluctance to commit to the framework is itself the primary driver of the ineffectiveness perceived in its implementation.

<sup>1</sup> Parliamentary Commission on Banking Standards, "Changing Banking for Good," June 2013.

<sup>2</sup> Office of the Comptroller of the Currency, "OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of Regulations," September 2014.

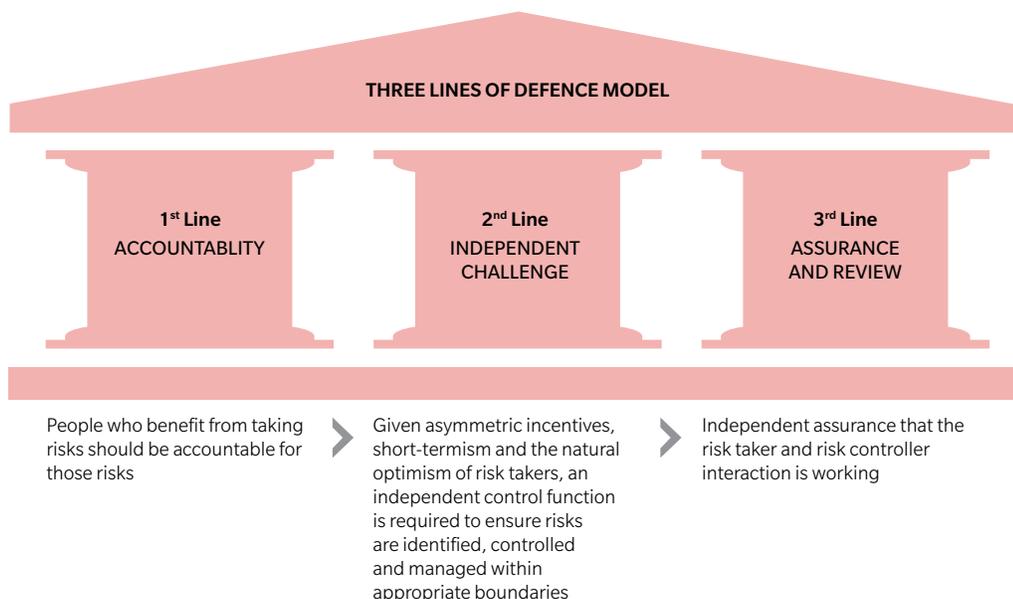
<sup>3</sup> Basel Committee on Banking Supervision, "Corporate governance principles for banks," July 2015.

# THE UNDERLYING PRINCIPLES OF THE MODEL

Despite the criticism, we believe that if put to sensible professionals unscarred by personal experience, the key tenets of the Three Lines of Defence would be met with a resounding chorus of approval:

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## EXHIBIT 6: THREE LINES OF DEFENCE MODEL



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- **Materiality-based risk management.** Independent challenge is most required where the ability to increase the risk is greatest – formulating strategy, pricing products, managing capital and mergers and acquisitions, etc.
  - **Independence of the risk management function.** Those individuals playing a challenger role must be legitimately independent, as evidenced throughout the organisation (reporting lines, governance, remuneration, etc.)
  - **Constructive and collaborative approach.** In addition to providing independent challenge, 2<sup>nd</sup> line risk managers will need to adopt a constructive and collaborative approach to deliver better business outcomes and avoid a “them and us” divide
  - **Rational, principled framework.** This should not be a rigid model that constrains sensible behaviour, generates workload and creates artificial barriers in the business, but a rational, principled framework providing guidelines and clearly set out compensating controls and governance wherever the standard model is flexed

# HOW IS YOUR ORGANISATION DOING?

If the principles underlying the framework, then, make sense, the real issue is in their consistent and rigorous implementation – and in presenting evidence of this to top management. How can the modern board director have full confidence in the reports they receive and the systems that are in place? We have set out a list of five tell-tale signs the organisation is living a lie, and a checklist of common and complex areas.

## FIVE SIGNS THAT YOU ARE LIVING A LIE

SIGN	WORRYING WORDS	DESCRIPTION
1 Whose line is it anyway?	<p><i>"We play more of a line 1 B role here"</i></p> <p><i>"If the Business Unit Risk team are 2<sup>nd</sup> line, what line is Group Risk?"</i></p> <p><i>"In reality, we cover all three lines of defence"</i></p>	<ul style="list-style-type: none"> <li>Widely differing opinions about who plays what role in which process</li> <li>Frequent allocation of 1<sup>st</sup> and 2<sup>nd</sup> line roles to one team or person</li> <li>"Assurance safety blanket" teams created by managers (especially under e.g. the Senior (Insurance) Managers Regime(s)) to provide regulatory attestation as wider model not trusted</li> </ul>
2 So abstract it is absurd	<p><i>"It's more of a high level construct here – we don't think it's appropriate to make it a bureaucratic mess"</i></p> <p><i>"Our processes are about people making the right decision – not what hat they wear"</i></p>	<ul style="list-style-type: none"> <li>Organisations have "adopted" the model but lack specificity to make it meaningful</li> <li>High level guidance is not translated into job descriptions, policies or process design</li> </ul>
3 Only answering the easy questions	<p><i>"The model just doesn't fit the reality of some parts of the business, and we are practical about that"</i></p>	<ul style="list-style-type: none"> <li>Reluctance to resolve the grey areas where 3LoD requires judgement in implementation</li> <li>See <i>Common Pitfalls Checklist</i> in exhibit 2</li> </ul>
4 Complacency breeds contempt	<p><i>"It's been like this for years – everyone knows their role"</i></p>	<ul style="list-style-type: none"> <li>Risk function organised in a different era and not overhauled since</li> <li>Model not updated for constant revolution in financial risk management</li> </ul>
5 Mind the gap	<p><i>"We know credit is our biggest risk, but the team has been so focused on Solvency II, we haven't looked at the portfolio in detail for some time"</i></p>	<ul style="list-style-type: none"> <li>Key tasks not explicitly owned or assigned to a particular team/line</li> <li>Risk function has broad mandate but resource is overwhelmingly regulatory and risk modelling focused</li> </ul>

EXHIBIT 7: COMMON PITFALLS CHECKLIST FOR THREE LINES OF DEFENCE

	CLEAR ROLES	1 <sup>ST</sup> LINE ARE MANAGING RISKS	2 <sup>ND</sup> LINE PROVIDE EFFECTIVE CHALLENGE
1 Risk appetite	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2 Business planning	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3 Capital management	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4 Risk/capital measurement	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5 KPI definitions/targets	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6 Credit origination/underwriting	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7 Pricing/product design	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
8 M&A	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
9 IT	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
10 Funding/liquidity	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

## GETTING IT WRONG – WHAT’S THE WORST THAT COULD HAPPEN?

The risks of claiming adoption of the Three Lines of Defence and crossing your fingers at the same time are serious:

EXPENSIVE	INEFFICIENT	DANGEROUS
<ul style="list-style-type: none"> <li>Redundancy of roles where poorly articulated or insufficiently well understood</li> <li>Significant additional process burden which does not actually deliver better risk management outcomes</li> <li>Lack of clarity results in management unwilling to reduce red tape without greater confidence in the model</li> </ul>	<ul style="list-style-type: none"> <li>Slow decision making as unclear mandates lead to prevarication</li> <li>Too much resource entangled in too few processes</li> <li>Lack of confidence in model leads to highly disruptive knee-jerk response to regulatory or board enquiry</li> </ul>	<ul style="list-style-type: none"> <li>Significant risk exposures may not be appropriately governed or controlled without a comprehensive perspective</li> <li>Lack of personal and departmental accountability facilitated by grey areas</li> <li>False sense of security provided to management and board by referring to but not implementing Three Lines of Defence</li> </ul>

Financial services organisations in the 21<sup>st</sup> century, with thousands of highly complex and technical decisions taken each day, rely on a system to be manageable. Creating order out of chaos is a Sisyphean task, but one which falls to managers and governors of modern financial services organisations. Ensuring this system is fit for that purpose is a regulatory imperative, with the introduction of new requirements like the Senior Managers and Senior Insurance Managers Regimes<sup>1</sup> in the UK, it has become a personal imperative as well.

<sup>1</sup> See FCA CP15/9: Strengthening accountability in banking: a new regulatory framework for individuals and PRA CP26/14: Senior insurance managers regime: a new regulatory framework for individuals.

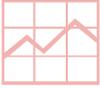
# WHAT DOES “GOOD” REALLY LOOK LIKE? HOW TO KNOW WHEN YOU REALLY HAVE ADOPTED THE THREE LINES OF DEFENCE

Financial services firms are complex, and we think it unhelpful and unrealistic to assume firms should channel resources into a theoretically pure implementation of the Three Lines of Defence model. It is, after all, intended as a framework for managing risk that can and should be tailored to each firm, and applied at a granularity that makes sense.

This sensibility notwithstanding, an effective implementation of the Three Lines of Defence does share the following common features. How many of these do you have in place?

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## EXHIBIT 8: FEATURES OF AN EFFECTIVE THREE LINES OF DEFENCE

	<b>DOCUMENT</b>	<b>Documented rationale for how and why and where the Three Lines of Defence is implemented in practice</b> <ul style="list-style-type: none"><li>• Process-by-process view, not a function-by-function view – ensure full coverage by starting from the risk, rather than the team</li><li>• Up to date, and reflected in resource allocations</li></ul>
	<b>EMBED</b>	<b>Fully embedded and universally and consistently understood</b> <ul style="list-style-type: none"><li>• Consistent response to the questions of who plays which role for which process from the relevant teams</li><li>• A common understanding of the compensating controls when (for entirely logical reasons) there is deviation from the norm</li></ul>
	<b>TEST</b>	<b>Periodic testing of how this works in practice</b> <ul style="list-style-type: none"><li>• Regular reviews to test the breadth and depth of independent challenge</li><li>• Reviews mix broad coverage with focused deep dives on areas of complexity or observed issues</li></ul>
	<b>REFRESH</b>	<b>Regularly refreshed for changes in the business</b> <ul style="list-style-type: none"><li>• Appropriateness of current model challenged periodically, and resourcing and mapping of the Three Lines of Defence should be closely linked to the Emerging Risk processes</li><li>• Reviewed after major changes to the business (M&amp;A, major change in product mix, enter new markets)</li></ul>
	<b>EVIDENCE</b>	<b>Finally, evidence of constant debate and challenge – if the answer is easy, it's probably wrong</b>

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Thorough and rigorous implementation of the Three Lines of Defence requires clarity of thinking and determination in execution. When the Three Lines of Defence framework is adopted with insufficient rigour, it is often because of an inability to get business, risk, and audit to jointly agree on the activities required and the ownership for each risk. Institutions will need to answer the difficult questions as well as the easy ones, and ensure the framework addresses the risks of each area appropriately as the business evolves. It's time to get started.

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