Insurance

The Windmill Principle: New Generation of Creditor Insurance

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The creditor insurance industry in the UK is now going through a process of regenerating itself and working out what the right product set is. But with the reputation of the product at its lowest ebb and with the Competition Commission remedies package yet to be finalised, how should the insurance industry deal with the issue and will it be able to cope with continued regulatory involvement?

The Windmill Principle

In an environment where creditor insurance is only associated with the terms misselling and reclaiming, the market potential of this product category is far from obvious. No longer is the creditor market generating £5bn gross written premiums in one year and gone are the days when the lack of customer awareness was more of a prerequisite than a hurdle. With the stagnant lending activity and the vigilant regulators it may seem that the banks' favourite pet has had its days. Figure 1 encapsulates the powers currently reshaping the creditor insurance industry.

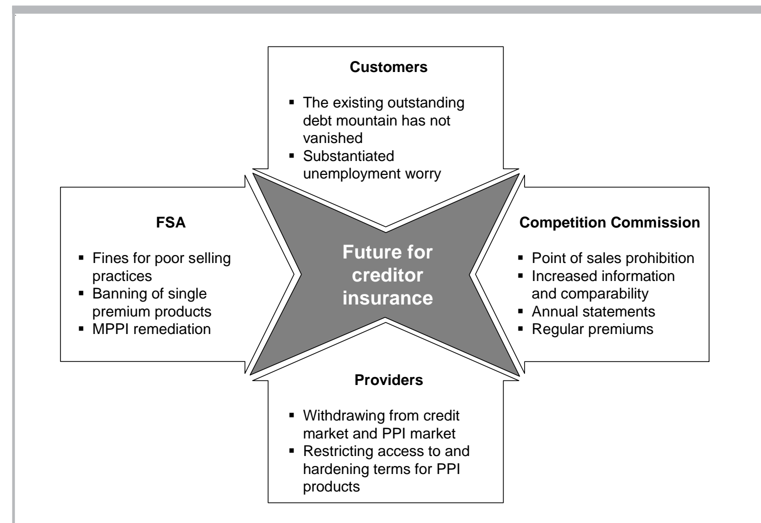

Figure 1: The Changes to the Current PPI Market

The days really are numbered for the poor value products that have over time failed to offer long term security, are restrictive, clause ridden and rely entirely on customer fear. Fines for poor selling practices are becoming increasingly common, single premium products have been banned, steps are being taken to introduce point of sales prohibition and annual statements – all with the objective of reducing the customer detriment, increasing the awareness and

product comparability. This is certainly a perfect storm, at least in the sense of drastically changing the market as we used to know it.

There is an old Chinese proverb: „When the storm comes, some build walls, the others build windmills". Since the start of the turmoil the number of distributors as well as underwriters in the creditor insurance market has been falling steadily. Even more are likely to withdraw or restrict their activities as the full spectrum of Competition Commission remedies is implemented. There will be others who will attempt to keep the existing second-rate products and squeeze them into the new market reality.

While some are „building walls" (e.g. by contesting the Competition Commission's ban on the sale of creditor insurance alongside consumer credit agreements and seven days thereafter), the customer preferences and needs are also undergoing a major shift. Although the recent recession slowed down the colossal growth of the debt mountain it still remains massive and the crisis also created substantiated unemployment worries and customer fear. Desire to protect and aspirations to save money have reached new heights. This suggests that the need for protection has not diminished. Even in the recessionary year 2008 the creditor market generated £3bn gross written premiums. On the contrary – the need and perceived value of creditor protection has never been more obvious as thousands of people have been protected against their homes being repossessed in the current economic climate. As a result of the deteriorating supply, much of the existing demand is overlooked or addressed in a suboptimal way and as a result of Competition Commission's ongoing effort to raise the customer awareness, there are fewer customers choosing products that only just meet the new regulatory criteria. Customers are starting to seek products that address their exact needs, that are easy to understand and that deliver actual value.

This is the opportunity for „building windmills" – coming clean about the past, putting the customer first and adding value back into the product that currently is an apparent underdog.

Three steps are to be taken to exploit the opportunity unfolded by the perfect storm (Figure 2):

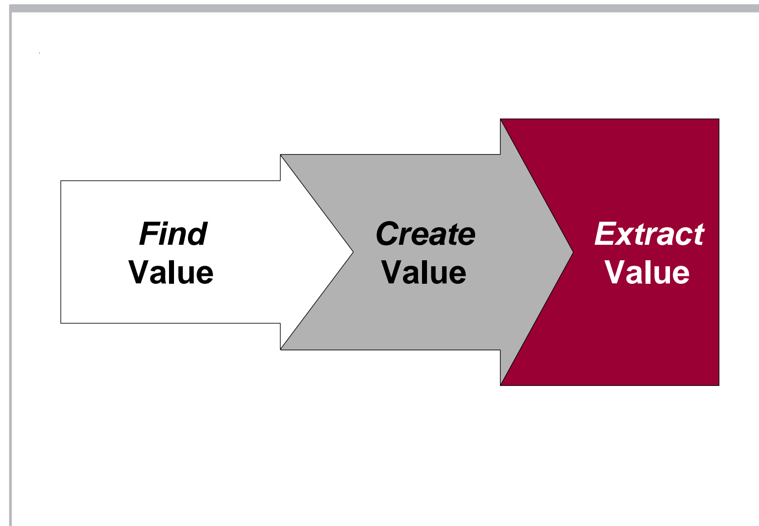

Figure 2: Three Steps to Turn the Storm of Change into a Competitive Advantage

1. **Find value** – protecting people against the unforeseen is what insurance is all about; however, there are millions of different ways to do it. It is therefore crucial to understand exactly which components are customer value drivers and which are overlooked entirely and consequently only drive costs without creating customer value.

2. **Create value** – having a perfect product is not sufficient if the sales processes and selling stories are not in place. To do the trick – the product and its built-in values need to overcome the sales people resistance and actually reach the end customer.

3. **Extract value** – while only products that recover the associated costs should see the light of day, it is important to measure the upside potential that each product has. Willingness to pay is the reflection of the value as it is perceived by the customer and it needs to be quantified and then used for setting the optimal price.

In the following sections each of the aforementioned steps will be discussed in more detail.

1. Find value: Know what drives customer purchasing decision

Despite the drop in the number of players, undoubtedly hit by the ban on selling single premium creditor insurance with unsecured loans, the market has been buoyed by a continued need for the product. Nevertheless, the products available in the market are far from optimal. Given the favourable environment for selling the creditor insurance in the past, it is not surprising that customer value has been an unfamiliar concept of little relevance. In the new market reality, the creditor insurance product will have to learn to stand on its own feet and this will only be possible if the product delivers what customers want.

It is a typical mistake to compensate the lack of knowledge about customer product preferences with an all-inclusive product with full-blown flexibility hoping that this will fit all. What is often forgotten is that an infinite list of features and unrestricted flexibility goes hand in hand with complexity, high costs of sales and administration and consequently also high end prices. In the end, customers are expected to pay a lot of money for products they do not really understand and at least partially (many of the bells and whistles) do not need. To hit the sweet spot while keeping the costs down it is crucial to understand what customers actually need and what their product preferences are. There is a number of methods available ranging from those that will deliver a 'quick and dirty' result to the state of the art methods that measure exactly how important one or the other feature is and how much is the customer willing to pay to have it. Decision on the most suitable method should be driven by the resources available and the required quality of the output. Figure 3 summarises the most commonly used methods for exploring the customer line of reasoning.

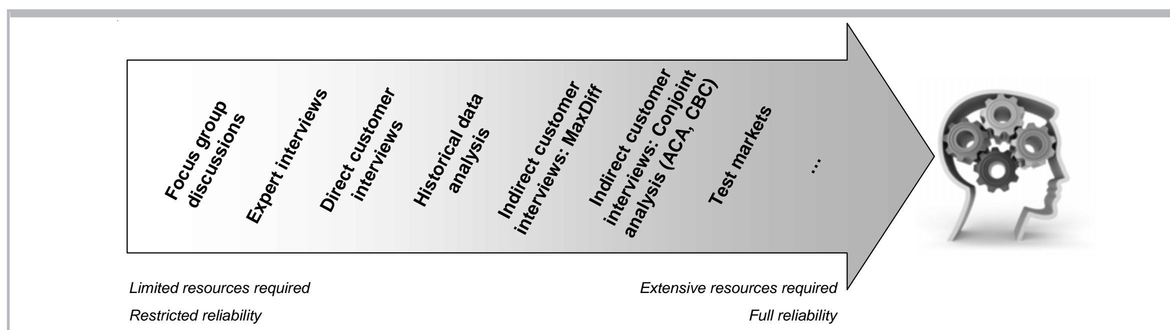

Figure 3: Methods for Understanding what Drives Customer Value

Some of the methods are more qualitative (focus groups, expert interviews) while others are more numbers based (historical dataanalysis, test markets), nevertheless all the methods to answer the following questions –

1. **What drives customer value?** (e.g. freezing the outstanding debt during involuntary unemployment or rehabilitation services that help driving down the time out of work)

2. **How much is good enough?** (e.g. by how much does the perceived customer value increase when the outstanding debt is frozen for up to 12 months as opposed to only 6 months)

3. **What properties should the product have?** (e.g. to what extent should the creditor insurance be separated from the underlying financial product)

4. **Do different customers want different things?** (e.g. if there identifiable customer segments in the creditor insurance market how do their product preferences differ and can all the segments be targeted with the same proposition)

These questions are crucial in the product development as well as the pricing process (as will be further discussed in the section on extracting value) and can provide a significant competitive advantage if addressed correctly.

Figure 1: The Changes to the Current PPI Market

2. Create value: Make sure that the right product actually reaches the end customer

Optimising the product is only the first step towards success. To ensure that the product actually reaches the end customers it is crucial to gain the sales people's acceptance and support. This is especially relevant in the current market when the allowed selling practices are undergoing significant changes. Value creation can only occur if the new selling strategy addresses the following three dimensions (figure 4):

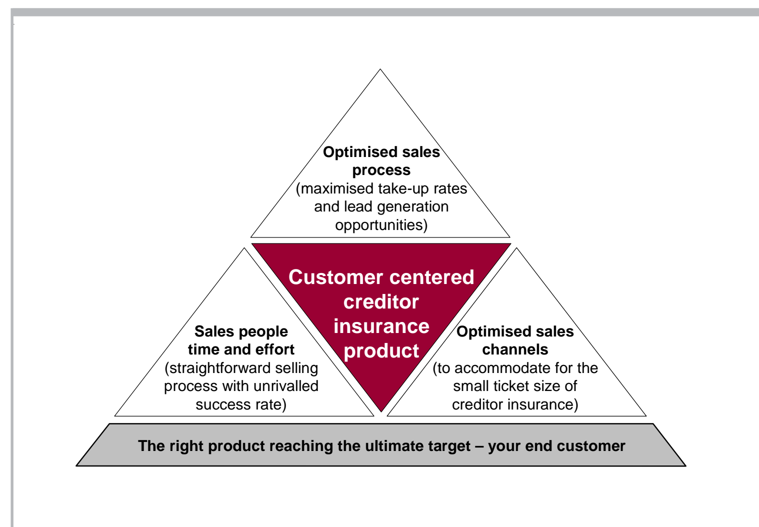

Figure 4: Ensuring that the Optimised Product Reaches the End Customer

1. Optimising the sales process

Given the Competition Commission's ban on the sale of creditor insurance alongside consumer credit agreement and seven days thereafter, it is important to establish a process that minimises the drop in take-up rates and offers ample lead generation opportunities. Customers need to be sufficiently incentivised to either actively return to the provider of the original financial product (be it credit card, personal loan or mortgage) and purchase the insurance before the end of the prohibition period or at least not seek other products but wait until the contact is initiated by e.g. the insurer at the end of the seven day period. If the sales person who is signing the credit agreement can correctly determine the customer's preferences and strike relevant selling arguments, the likelihood of completed sales increases dramatically. The opposite is true if there is no mention of the insurance product or the selling process is initiated with the product's price when speaking to a highly

price sensitive customer. The new sales processes will needto increasingly focus on customer retention, with no claims discounts and variations on renewal. It will be as important to keep a customer as it is with household and motor insurance.

In summary - it is important to have a formal sales process in place that ensures adequate lead generation which the sales people cannot opt out of. To increase the probability that the generated lead results in a completed sales, sales people should be equipped with a straightforward process of finding out customer preferences (e.g. a decision tree with three short questions that can allocate each customer in one of the buckets – „no frills", „all inclusive" and „convenience" seekers) and matching them with tailored sales arguments.

2. Selecting the optimal sales channel

As the full spectrum of Competition Commission remedies will be implemented, insurers are likely to seek alternative sales channels to accommodate for the small ticket size of creditor insurance products. The tendency will be to reduce the reliance on the face to face channels and increasingly exploit internet, telephone, TV, ATMs and self-service kiosks. As the product starts to merge into the stand-alone income sector, the customer will have to contact the distributor for the product. In such a case what we will see is incentives, such as discounts and periods of free coverage, to encourage consumers. Meanwhile, it is essential to keep in mind that different sales channels can handle different levels of product complexity and a leaner version of the creditor insurance product will be needed for the more self-administered sales channels. A number of insurance companies in Latin America demonstrate a great example of successfully integrating ATMs and kiosks in their distribution strategies.

In brief – the changes in the regulatory environment will inevitably force the insurance companies to rethink their sales channel strategies. While many insurers still focus on the face to face sales, there is a competitive advantage to be gained by the fast movers through wider access and lower sales costs of alternative sales channels.

3. Getting sales people time and effort

Face to face sales will not be replaced entirely; therefore, certain effort needs to go into ensuring that the creditor insurance products are able to compete for the sales people time and effort with other products in the respective portfolios. Sales people need to be sufficiently incentivised to invest their time into generating leads instead of moving on to the sales of another e.g. banking product. It is fair to assume that creditor insurance, being a small ticket product, cannot compete with other products in terms of the commissions that sales people can earn. Nevertheless, sales people do not think only in terms of commissions. The other variables in this equation are the expected success rate (how many of the initiated sales actually go through) and the time/effort required to close the deal (how many products can be sold over the available timeframe). Our extensive project experience reconfirms that typically sales people allocate their time and effort on the basis of the following calculation: „After completing all the administrative tasks, I have X minutes left for selling. Within that time I can make Y sales calls which will result in Z completed sales earning me commissions of W". Normally high per piece commission comes with low success rates and high administrative burden; therefore, there is the potential to compensate low commission with higher volumes per sales person.

In the nutshell – while creditor insurance will never be attractive for sales people from the commission's perspective alone, lots can be done to achieve a straightforward selling process (i.e. leaner than for any other product in the portfolio) with unmatchable success rate achieved through optimised products and processes.

3. Extract value: Ensure that the optimal price is charged

Price is the flipside of the value and while only products that recover the associated costs should see the light of day, it is important to quantify the upside potential that each product has and set the price accordingly. However, pricing is not solely about attaching a price tag. To unfold the full potential of pricing, the following aspects need to be taken into account (Figure 5):

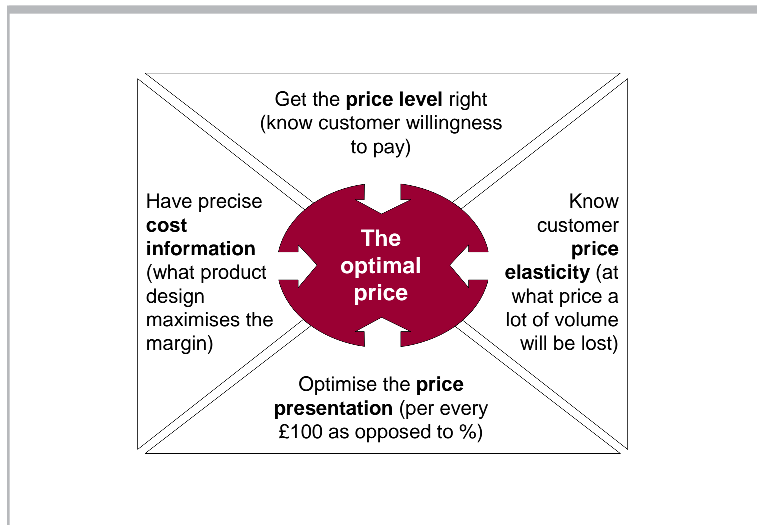

Figure 5: Achieving the Optimal Price

Aspect 1: Price level

The rule of thumb is straightforward – Excess willingness to pay has to be translated into higher prices and insufficient willingness to pay (i.e. lower than the costs associated with the product) must lead to reconfiguring the product. The same methods as outlined in the section on finding value can be used also to measure the perceived value or rather its translation into willingness to pay. Any of the indirect questioning methods is suggested over the direct ones as these are likely to result in exaggerated sensitivity to price and consequently – lower than the actual willingness to pay.

Aspect 2: Price presentation

The impact that price presentation can have on the perceived 'expensiveness' or 'cheapness' of a product is typically underestimated. Price presentation is more than just changing the price from £10 to £9.99. Optimising the price presentation in the creditor insurance context should

also address the basis on which the price is calculated and the used price metric. A number of projects have confirmed that there are significant differences in how customers perceive the price if it is presented as a percentage of the outstanding liability as opposed to being presented per every £1,000 (or £100, or £10,000). In addition, the real price level may stay the same, but changing from £0.60 per every £100 of the outstanding balance at the end of the month to £0.80 per every £100 of the average outstanding balance throughout the month can lead to major impact on how the customers perceive the price. However because there is no general rule, it is important that insurance companies find out these peculiarities for the specific customer base that their products are configured to address.

Aspect 3: Customer price elasticity

Price optimisation relies on the price-response function, which aggregates all the possible price and volume combinations that are derived by comparing the willingness to pay of (ideally) each customer with different price levels and only where the willingness to pay is equal or higher would a purchase take place. The price-response function is the cornerstone of smart pricing. It is impossible to make any good pricing decisions if you do not know how price and volume are related. On the basis of the price-response function it is then possible to calculate the price elasticity – the key concept in professional pricing that measures the change in quantity as a result of a change in price. The higher the elasticity, the larger the impact of price changes on demand. Typically it is possible to detect a price point above which a significant drop in volume would occur. This point is called price threshold and it serves as an important road sign on the way to smart pricing.

Aspect 4: Cost information

While costs go up exponentially as the product's performance is improved, the perceived customer value and subsequently the willingness to pay normally increase much slower - if at all. The question that needs to be answered is: What would be the optimal product attribute and benefit level combination so that the value created would overcompensate the costs associated with offering

the product and the overall profit is maximised taking the volume reaction to price changes into considerations?

Conclusion: Changing to Survive

Major changes are happening in the creditor insurance market and for some the perfect storm may be less than perfect; however, new opportunities are unfolding and 'windmills' not 'walls' are needed to fully exploit them. FSA style oversight will continue, competition law will open up the market and political as well as media pressure will persist. Portability of creditor insurance will become a norm. Nevertheless – customers want and need creditor insurance; therefore, providers need to take stock of the product to ensure that it is good value and finally become proud of it and their selling ability. Putting the customer first and redesigning the product as an enhancer will be the only way to survive and prosper in the changing market.

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