**The Changing Financial System and Life Insurance**

**Kevin Davis**

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1. **Introduction**
   1. The last twenty years of the twentieth century were ones of great change for financial institutions and their staff, who have had to cope with the impact of deregulation and financial reform, increased competition (both with traditional competitors and with other financial service providers), and explosive growth in new technology. The outcome has included a widely expanded range of financial products, new methods of delivering financial services, and increased attention to costs, risks, and profit contribution.
   2. Expect continued change. The regulatory environment is likely to continue to change. Like a dog chasing its own tail it will continue to adapt in response to changes in financial markets which it in part induces. Competition will continue to be pervasive as financial service providers mutate and seek to invade the turf of non-traditional rivals. The types of competition will continue to change as the technology explosion alters the costs of different ways of creating and delivering various financial products.
2. **Electronic Commerce**
   1. Over the past twenty years, technology has already altered fundamentally some features of the financial system. Bank payments services are a good example. Payments services have evolved from predominant reliance on cash and cheques, through paper based credit card facilities, direct credit of payrolls, and debit cards to popular acceptance of EFTPOS and ATM facilities. More recently the development of trade and payments via the internet, and of stored value cards, are accelerating the pace of change.
   2. Such changes have had significant effects on bank cost structures, and the ability for customers to access payments services without interacting with bank staff has had an effect of “depersonalising” banking. Similar features are relevant for other areas of the financial sector such as the life insurance industry as customers will be increasingly able to obtain information about alternative services via the internet and purchase life products via the WWW. Given the growing competitive significance of customer loyalty (discussed below), this depersonalisation creates some major challenges for strategists in financial institutions.
   3. The pace of change seems certain to accelerate in coming years. Growing penetration of home computers and telecommunications development are likely to see continued depersonalisation of financial services (and changes in the number and type of staff required to provide such services).
   4. “Phone banking” is already with us: automated bill paying services, over-the-phone purchases, account queries, can all be effected without any human interaction, unless responding to a recorded voice is put in that category. “On-screen banking”, where a computer terminal replaces the phone, removes even that interaction, and the growth of the Internet is bound to cause an explosion in such activities, as more and more businesses advertise and provide purchase facilities on the Internet.
   5. Business over the Internet involves problems and opportunities which are familiar to financiers. Technology can ensure that payment can be effected immediately at a keystroke, but delivery of merchandise takes time. Standard trade finance issues assume importance, providing financiers with business opportunities from facilitating trade on the Internet. Delivery of financial services can be divorced from physical location of the supplier relative to the consumer. Competition becomes increasingly global – unless national regulators create barriers which prevent such developments
   6. Regulators and Governments face significant problems from such developments. Consumer protection becomes more complicated – as customers can access (via the internet) suppliers of services who operate outside of their physical jurisdiction. Traditional measures of market competition and power start to look less robust, as markets become more contestable by physically far distant competitors. Prudential regulators face problems of dealing with financial institutions whose activities increasingly cross national boundaries as physical presence becomes less of an impediment to service provision.
   7. These likely developments also raise numerous issues for national governments in the area of competition policy associated with the operation of the next generation payments technology. First, who will control the technology and systems? What financial institutions should be allowed to participate in the provision and recharging of stored value cards? Second, the cost structure of the payments system will be further changed in the direction of larger fixed cost elements (on computers, networks etc.) and lower variable cost elements (paper processing involving labor costs, branch office costs etc.). To what extent should a concentration of market power be allowed to emerge in control of the payments network, and how should access of other participants at fair prices be ensured.
3. **Customer Focus**
   1. Once, customers of financial institutions typically remained loyal for life to the financial institution they first embraced. Now, like that other great social institution of marriage, lifetime commitment is no more, and financial institutions must continually woo their existing customers.
   2. Here financial institutions walk a tightrope. They appear to profit most from long term customers. A prime objective is thus to entice customers away from competitors into a long term relationship creating fierce competition in the area of “special deals” for new customers. The risk is that unless one’s own long term customers are looked after they will be poached by others pursuing similar strategies. If long term customers are not to be lost, financial institutions need to ensure that they share with customers some of the cost savings that a long term relationship brings, and avoid excessive exploitation of customer immobility resulting from account transfer costs.
   3. The ongoing challenge for financial institutions is thus to develop pricing structures for services which achieve three goals. First, they must provide incentives for new customers to switch business. Second, they must provide incentives for long term customers to remain with them, and/or increase the costs of leaving. Third, the overall pricing structure must deliver adequate profits. It will be necessary to pass on to long term customers some part, but not all, of the benefits of lower costs of long term accounts, and cross subsidise new customers in the hope of recouping those subsidies as a long term relationship develops.
   4. As with any situation where cross subsidisation is involved, this is fraught with dangers. Longer term customers may leave if their share of cost savings is felt inadequate, although by doing so they destroy the asset (a long term relationship) which creates their potential benefit. New customers may be easily enticed away, so that initial subsidies are never recouped. For pricing strategies to work, they must be carefully designed and continually adapting to changes by competitors.
   5. For long term relationships to evolve, financial institutions need to examine how to best respond to the technological depersonalisation of the financial services industry. At the business/institutional level, strategies which appear relevant include:

* greater emphasis on the roles of account relationship managers to create personal links;
* provision of specialised advice and services upon which the customer becomes reliant;
* inducing customers to “lock in” to software etc. which interfaces with the financial institution’s systems (and is costly to change from).

At the retail level, the continually growing importance of the financial advice and planning industry indicates an area in which financial institutions can expand services in a way which encourages customer loyalty. Both suggest an different skill base and career path for employees to that traditionally seen. In the life industry, the future of agents specialising in selling life insurance products seems threatened by both this development.

1. **Fee for Service**
   1. Until recently, financial institutions have not had particularly good information about the costs of providing various services. In a regulated, less competitive, market place, knowledge of cost drivers was less relevant than it is today. Nowadays, financial institutions have in depth knowledge on the cost of particular services (although allocating many costs is somewhat conjectural). While prices for particular services are driven by competitive pressures, better estimates of profitability by lines of business are now available.
   2. Increasingly, adequate profitability of individual lines of business is being required. The stock market emphasises the need for a return on equity capital adequate for the risks involved, and penalises the share price of financial institutions not delivering. The regulatory approach to supervision of financial institutions, based on risk weighted capital requirements, has further focussed management’s attention on the cost of equity capital. Those external pressures find internal reflection in the need for business units to return an appropriate risk related return on capital employed, and to do so by appropriate pricing of individual products to recover both explicit costs and required return on equity capital.
   3. The need to return an adequate return on individual products arises because given the mobility of customers, or more particularly their money and business, it is not generally feasible to cross subsidise the provision of some products at prices below cost by excessive charges on other products. Customers, naturally, use intensively the products which are subsidised and shun the expensive products, so that no excess profits are made to support the cross subsidisation.
   4. That does not mean that some cross subsidisation is not feasible across products where customers consume them as a “package”. A retail transactions account, for example, involves a payments services facility (itself incorporating many individual services) as well as a deposit facility. Some forms of cross subsidisation across these services are feasible if they limit the extent to which customers can exploit the cross subsidisation, and this is reflected in the variety of systems of account fees and charges used by financial institutions. In the life insurance business, whole of life and endowment policies combine both long term savings and insurance services. Notably, the ability of competitors to provide unbundled packages of term insurance and alternative savings vehicles creates a need for more explicit attention to pricing of such packages.
2. **Industry Structure**
   1. The composition of the financial industry will change, under the influence of number of factors. First, there will be continued increase in the degree of international competition. National barriers to entry into domestic markets are continuing to fall world wide. Standardisation of prudential regulation via common capital requirements based on international proposals also levels the international playing field. Combined with modern electronic technology, which reduces the significance of geographical location, commonality of prudential supervision may enable far distant institutions to compete with locals for some parts of the financial services market, even in retail markets. Absent restrictive entry legislation, competition for business in the era of modern technology is increasingly global rather than national.
   2. A second factor affecting the structure of the financial services industry is the impact of modern technology on the cost structures of institutions of different sizes. Numerous statistical studies have shown that there is no evidence to support the view that “bigger is better” from a cost perspective. Average costs do not appear to decline as size increases, but with the changes in technology currently being experienced, that historical evidence based on old data may be outdated. Certainly, managements of financial institutions appear to believe that bigger is better. That phenomenon may reflect their personal prestige arising from running a larger organisation, or the fact that greater market power may arise from larger size, or that certain attractive activities can only be conducted by large scale institutions.
   3. Blurring of the boundaries between banking and other financial service providers is a continuing phenomenon. Banks are expanding into new areas, as evidenced by the growth of “bankassurance”, the combining together of traditional banking and life insurance / funds management activities. All types of institutions are continually facing new competitors. Mortgage Brokers (such as Aussie Home Loans) have recently made their presence felt in Australia, giving a new lease of life to the securitisation industry and a new source of competition to the housing loan business of banks. Financial planners and advisors have usurped the traditional role of the bank manager and life insurance agent as a source of advice, and increasingly influence the direction of savings funds of their advisees. Large companies are increasingly developing sophisticated in-house treasury functions which enable them to undertake activities previously provided to them by banks. The funds management industry has boomed, with an explosion of mutual funds (unit trusts) available to investor / savers and combined with growth of superannuation savings has led to an increasing proportion of savings bypassing the traditional banking industry or the role of whole of life and endowment policies as forms of long term savings.
   4. A fourth factor influencing change relates back to customer relationship issues. Recent years have seen the development of branded credit cards and credit point schemes enabling receipt of benefits from particular businesses associated with credit card schemes. The objectives of such schemes are to encourage cutomer demand and “lock in” continued business, ie to promote customer relationships. This can be expected to continue, and liaisons between banks, life offices, and large businesses further developed.
3. **Organisational Structure**
   1. Over recent years, financial institutions have changed dramatically their internal structures and organisational arrangements in the face of an evolving financial services industry. Organisational charts have been, virtually continuously, rearranged, the security of employment reduced, and relevance of traditional career paths reduced.
   2. These changes seem likely to continue. As financial institutions adapt and the range of activities undertaken expands, it is unlikely that organisational structures will remain unchanged. Institutions will have to grapple with the task of assimilating quite differing cultures (and salary arrangements) as that occurs. The bottom line, though, is that traditional services and the careers based on those services are unlikely to be growth areas. Experience will remain important, but a greater emphasis on computer literacy and financial education and knowledge will be required to cope with the modern financial system and provide service to customers.