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Insurance

Balancing the scales

Toward a stable and dynamic insurance future

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Balancing the scales

Toward a stable and dynamic insurance future

By Christian Bieck and David Notestein

After the storm, the financial world is searching for a new order. While banking institutions are wondering where they will make money in the future, the insurance industry has always felt secure in its stability. Insurers are facing a different issue: how to balance the fundamentals that shaped the industry and made it strong with the dynamics created by an empowered customer and an uncertain global environment.

Introduction

In an increasingly integrated financial world, where banks sell insurance products and insurers invest huge sums globally and offer products once considered the domain of wealth managers, all-in-one-finance as the ultimate goal of the insurance industry looked like a given. But what does "financial services" actually mean for customers, both private and corporate? How does the insurance industry differ from other financial services companies? How is it the same? What disruptors and trends will affect the future of insurance? And what part will the continuing global financial crisis play in shaping this future?

To answer these questions, we surveyed more than 8,000 consumers and interviewed 150 insurance business executives to assess the industry's drivers and inhibitors, as well as the role of the customer of the future and the overall competitive environment.

We found a strong industry with quiet doubts – secure in the role as calculator and bearer of risk, but still unsure of what other goals to pursue and niches to fill. As one interviewed executive noted: "Some people want to insure a car, and some people want to purchase mobility – we know how to do the former but are still trying to solve the latter."

In our findings, the landscape of insurance balances around four fundamental variables:

- Long-term policyholder needs versus short-term capital market requirements. This variable affected even those insurers not publicly owned, albeit indirectly, due to their investment portfolio and competitive pressures
- The regional nature of the insurance business versus the growth potential of globalization
- The prudence and conservatism that keeps the industry anchored versus the vision and innovation necessary to assure a healthy future development
- Providing value to insurance customers versus the imperative of managing the customer portfolio towards sustainable returns.

Finding the right weights to assign to these variables will play a crucial role in balancing the scales and creating a stable and dynamic insurance future.

Research methodology

The IBM Institute for Business Value surveyed more than 8,000 industry participants, including about 150 insurance executives, to determine the future trends and drivers of the insurance industry. The survey, which was undertaken with support from the Economist Intelligence Unit (EIU), was conducted between August 15, 2008, and April 27th, 2009. It incorporates the views of representatives from a wide range of organizations:

- Life insurers, including pensions providers
- P&C insurers
- Comprehensive providers (bancassurers)
- Other (academics and regulators).

Thirty-three percent of the respondents are based in the Americas; 35 percent in Europe, the Middle East and Africa; and 32 percent in Asia. The majority of those who work for insurance companies are board-level executives and their direct reports.

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The insurance industry has, historically, operated more conservatively than other elements of the financial services sector.

Insurance versus the capital markets: Taking the long-term approach

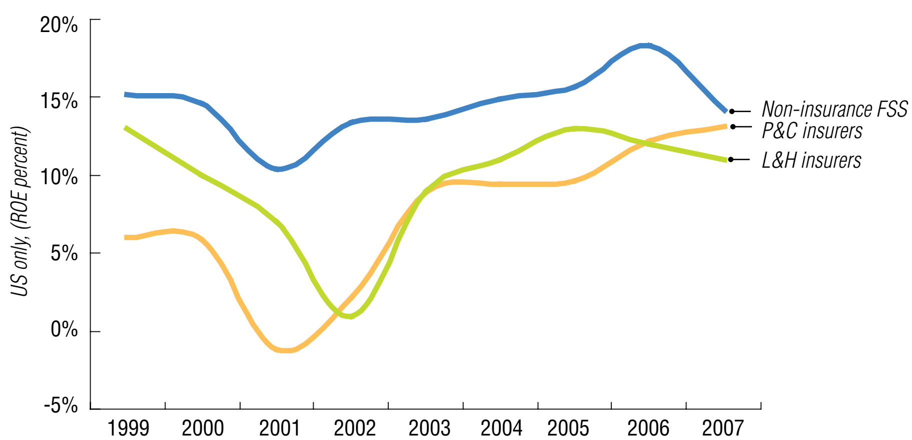
The financial services sector (FSS) is a complex animal. Definitions of what constitutes FSS vary, ranging from "banks and insurers," to "organizations that deal with the management of money," which include such diverse enterprises as credit card companies, hedge funds and leasing companies.[1] During the last decade, analyst and investor attention has become increasingly focused on this sector – in 2006, for example, while U.S. GDP share of the financial sector was merely 8.3 percent, its share of corporate profits was 14 percent and its market capitalization in the S&P 500 index was more than 20 percent.[2]

As we showed in a parallel study, published in April 2009, a significant part of the high yields in the financial sector, specifically in banks and financial markets companies, resulted by creating and exploiting "pockets of opacity".[3] Increasingly complex financial instruments, a largely unregulated shadow banking system and high debt leverage allowed industry profitability and expansion far above other sectors. This profitability was "bought" with higher risk assumption and by implicitly accepting (or ignoring) the possibility of systemic shocks due to the interconnectedness of financial instruments and assets – i.e., the banking industry "put all eggs in one basket" – with the known results.

Conversely, the insurance players in the financial sector, on average, operated more conservatively. Even in the mainly bull markets of the past decade, this led to consistently lower returns (see Figure 1).

In the economic storm that started slowly in 2007, and has magnified since the Bear-Stearns, Lehman Brothers and AIG incidents

FIGURE 1.
Returns on equity in the U.S. financial services sector, insurance and non-insurance.



Source: Insurance Information Institute; IBM Institute for Business Value analysis.

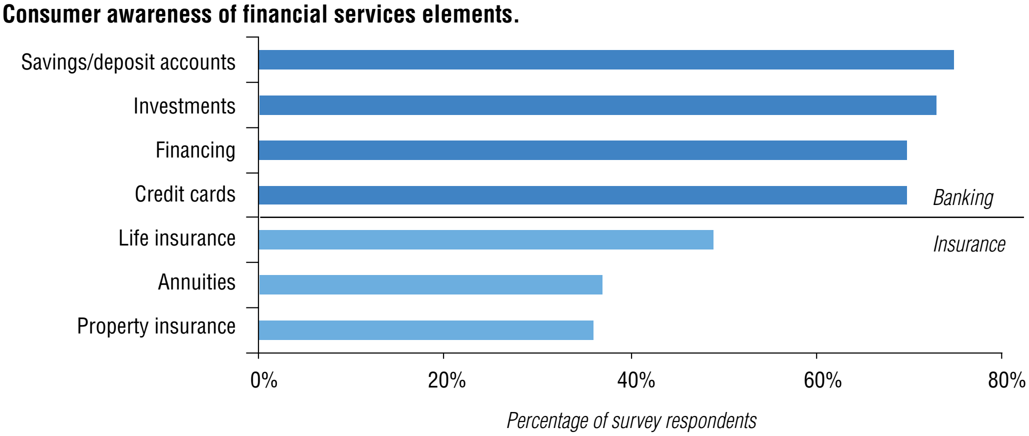
in late 2008, the stock markets punished all financial firms similarly. Between July 2007 and March 2009, global financial services market capitalization dropped 67 percent, with the largest insurers contributing 64 percent to that decline.[4]

This market reaction is surprising on several levels. The business of insurance is still sound – the same corporate policies that led to lower returns also led to considerably less exposure from risky assets. While central banks globally are worried that the basic function of banks – lending to the real economy – is damaged, "the basic function of insurance – the orderly transfer of risk from client to insurer – continues uninterrupted."[5] This is certainly true of property and casualty (P&C) insurers globally, most of which showed excellent combined ratios in 2008 and the first quarter of 2009. And, to a lesser extent, it is also true of life, pensions and health insurers. In their case, the decline of asset values does hurt the bottom line, but not the pure operational results. Any impact is an expected normal factor of the business cycle. Even though the current downturn is not quite "normal," there is still no reason to see the declining operational results as part of the financial crisis.

Unlike the markets, financial services *customers* do distinguish very well between banking and insurance type services. In our consumer survey, we listed a number of services typically associated with FSS by experts and asked respondents to choose which ones they would associate with FSS. As Figure 2 shows, from a consumer standpoint, insurance is not really a part of the financial services sector.[6]

Additionally, we checked for attitude changes during the crisis. On the question whether insurance companies in general can be trusted, we received answers that were consistent with a recently released study by the IBM Institute for Business Value, "Growing trust, transparency and technology: Insurance customers' perspectives in a global context" (T3).[7] Trust in the insurance industry was low

FIGURE 2.
Consumer awareness of financial services elements.



Source: IBM Institute for Business Value consumer survey, n=7,655.

Trust in the insurance industry, while low, has not dropped appreciably during the global financial crisis.

(37 percent), but this level did not change from August through December 2008, despite the AIG incident. In contrast, we found a sharp drop of five percentage points in the banking industry, lowering trust level from 48 percent to 43 percent. This confirms not only that the banking industry is approaching the same image issue we identified for insurance in T3, but also that consumers do distinguish between the various parts of the finance sector.

> "The insurance industry has a unique position: it looks mainly for long-term returns, even in public companies."
>
> – Director, UK public all-lines insurer

As our interviews found, what keeps executives in the banking world up at night is the uncertainty of their future business model. Insurers worry about "focusing too much on the short term".[8] In principle, they don't have to worry: the industry fundamentals and long-term megatrends revealed in our 2006 study, "Insurance 2020: Innovating beyond old models" – the active and informed customer, the componentization and virtualization of the value chain, the change in products and services that bring smaller, smarter, building-block type approaches and the globalization of regulation – continue to be valid.[9]

Globalization versus regionality: Grow globally, act locally

Historically, segmentations in the insurance industry have been based on demographics, with traditional criteria like product, price or convenience as perceived behavioral influencers. While these criteria are valid, additional key segmentation criteria must be analyzed by any insurance company wishing to service its market well – i.e., to really understand the consumers' view of financial services and their approach to the purchasing and use of these services.

From the consumer survey conducted for this study, analysis of the responses on attitude and behavioral factors resulted in six statistically distinctive segments. The segments, their size, key themes and how they might be approached are shown in Figure 3. As the

FIGURE 3.
Psychographic/attitudinal segmentation classifications of financial services customers.

Segment	Uninvolved Minimalists	Price-sensitive Analyzers	Active Demanders	Trusting Service Expectants	Convenience Desirers	Ethics Seekers
Percentage of total	19.1%	21.4%	20.6%	9.2%	21.9%	7.9%
Key theme	"Finances are important, but I don't know how"	"I want the best bargain"	"I want it all, and I want it now"	"I have special needs, and I want them taken care of"	"Make it easy for me at whatever cost"	"I want a smarter, more responsible provider"
How to approach them	Prepackaged products, one-stop shop	Standardized, transparent and efficient	Best-in-class	Through competent advisors	Simple and standardized	With ethical standards of excellence

Source: IBM Institute for Business Value consumer survey, n=7,655.

analysis showed, there are overlapping dimensions across these segments (e.g., pricing is key to both Price Sensitive Analyzers and Active Demanders, and service is important for both Convenience Desirers and Trusting Service Expectants). Of note is the “Ethics” segment that is looking for its provider to be pursuing business activities meeting standards in such areas as “social responsibility” and the environment. While the size of this segment tends to be overestimated due to the volume and outspokenness of its members, it is worth keeping a close watch on to see whether and when this type of attitude becomes an exploitable trend.

Consistent with previous studies, the segment distribution varies significantly across countries: the main differentiator is not any demographic variable, but the regional background of respondents.[10] For example, in developed economies, the percentage of “Trusting Service Expectants” ranges from 9 percent in France and Germany to 19 percent in the United States and United Kingdom, and goes all the way down to 2 percent once we start including countries such as Poland and China.

These differences create some of the major challenges that insurance companies have in attempting to operate in multiple countries with a relatively simple and undifferentiated approach. Failure to understand the differences in attitude and behavior per country or region will likely reduce an organization’s ability to develop competitive products and services, especially when compared to those organizations that can. These differences have been built upon years of culture, legal considerations (both case and regulation based) and competition. A “one-size-fits-all” approach for insurance across regions, or in fact within a region, will not work.

“Trying to fit international methods and results to our local market cannot and will not work.”
– Director, European all-lines insurer

The regional nature of insurance attitudes can also readily explain the mixed success of various business models. One of these is the bancassurance model, which is working fairly well in some countries, such as France or Finland (at least for life insurance[11]), and less well in others, such as Germany. When explaining this fact, commentators generally tend to overemphasize factors like regulation and ignore cultural factors.

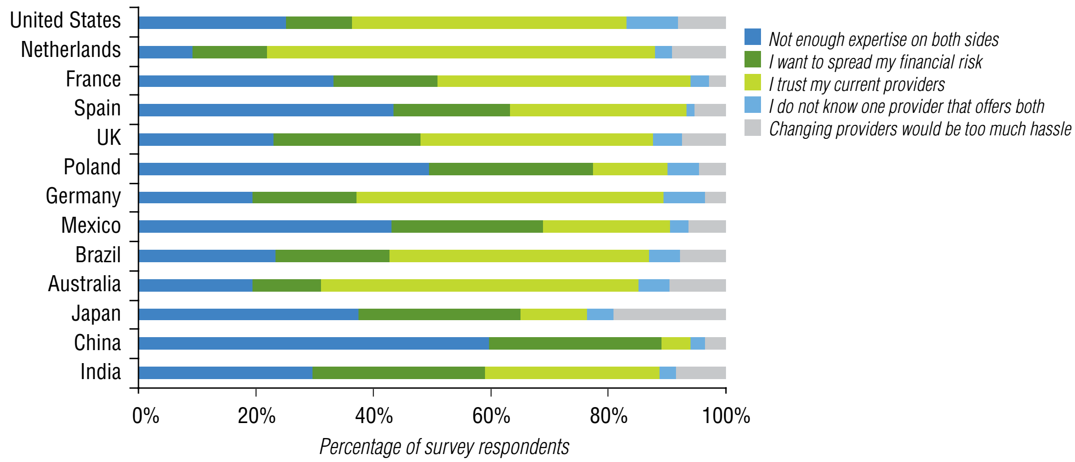
We explored why consumers won’t accept bancassurance. The findings again show large regional differences in the spread of reasons – as they do in the question whether consumers would want bancassurance in the first place (see Figure 4). The reasons for non-acceptance have several dimensions: the fact that the individual already trusts his or her current provider (retention dimension), that the alternative provider does not possess the necessary expertise (rejection dimension) or simply the resistance to change (inertia dimension).

Again, one size does not fit all: those companies that have been successful in developing a bancassurance position in some regions cannot necessarily use the same model for all countries.

The basic nature of insurance is very much that of a locally or regionally defined product. While there are global aspects of finance, communication, education, technology and development, the risk assumption nature of the insurance product is built upon local knowledge and expertise (underwriting, rating,

Most customers agree: insurance is not a luxury, but a basic necessity.

FIGURE 4.
Reasons for rejection of bancassurance.



Source: IBM Institute for Business Value consumer survey, n=2,100.

pricing), as well as locally defined regulations, laws and legal concepts (e.g., coverages and claims). As has been said by others before, and insurance continues to demonstrate, it may be useful to think globally, but you must analyze and act on a very local basis in order to meet the needs and expectations of the customer.

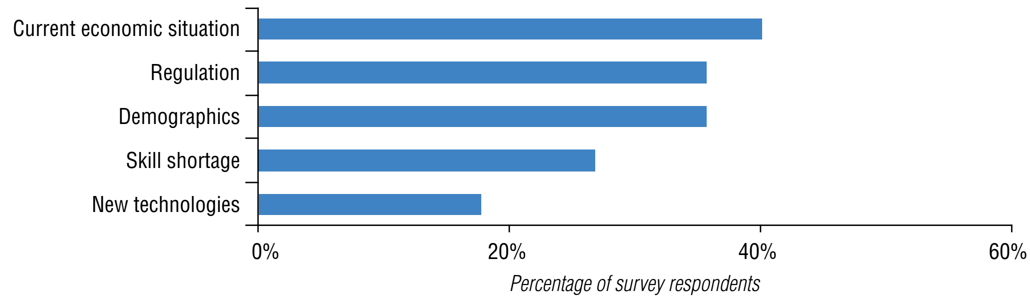
Prudence versus innovation: Using the fundamentals to keep moving

As mentioned, operational results of most insurers have been at least reasonable, despite the economic climate. This is due to the fundamentals of insurance staying unchanged – the law of large numbers, principles of selection and anti-selection and, especially, actuarial science – but also of insurers sticking to these fundamentals in the way they operate.[12]

Still, we can expect some type of change. Figure 5 shows the forces that will shape the industry most, according to the insurance executives we interviewed.

The *current economic situation* seems an obvious disruptor, and yet again executives agree that its impact does not go beyond the "normal" recessionary tendencies. Effects will likely be delayed. In the countries we surveyed, more than 75 percent of insurance customers agreed that comprehensive risk protection was important, meaning that insurance is not a luxury good, but rather a basic necessity. Tighter economic conditions will likely result in lower amounts of new business, with the resulting decreased revenue streams (due to both lower growth and the absolutely lowered economic activity of existing businesses) and lower budget for anything except the most critical elements to support the enterprise.

FIGURE 5.
Top five disruptive forces for the insurance industry.



Source: IBM Institute for Business Value interviews, n=22.

The impact of *regulatory change* is more uncertain. We can see two conflicting tendencies here: on one hand, insurance regulation has always been highly regional and "proprietary" on a country-by-country, or even state-by-state (in the United States) level. On the other hand, with many insurers operating across borders, a need for coordinated regulation and oversight is recognized and, with the financial crisis, initiatives like Solvency II and NICPA gain more weight.

Insurers are fairly divided on these issues. For the United States, a system of 50 parallel (and, in places, conflicting) state regulations has worked remarkably well in protecting policyholders. But, at the same time, the "system has brought insurance innovation to a standstill. The industry has not introduced a single entirely new property and casualty insurance product for individual customers since […] 1950."[13] While it is debatable whether the lack of innovation was due to the state regulatory system, or due to complacency in an industry insulated by other competitive factors (e.g. specialized skills, large back offices, need for distributed sales channels), our interviews suggest that changes in regulation will have the effect of pushing insurers towards increased efficiency and flexibility – both of which are prerequisites to innovation.

Beside the regulatory system itself, even the promise (or threat) of changing regulation often stifles innovation. As one European insurer told us, even though the company considered some of its service processes to be inefficient, it felt could not effectively change them because national legislation was pending. So, the insurer decided to do nothing. This reasoning is common, but fails to consider the nature of innovativeness: a provider needs a flexible framework to be able to change quickly. This framework starts in employees' minds, includes flexibility of the organization, and allows applications and processes (through rules) to change quickly.

New technologies will force change by allowing enterprising insurers and new market entrants to introduce new offerings.

As participants in a previous IBM study put it, "innovation isn't a department, it's a culture".[14] To summarize: even though we do not know the exact nature of future regulatory changes, insurers that do their homework today will come out ahead because they are able to react more quickly and with less cost – and they will be able to use that flexibility in other areas, too.

The third and fourth disruptive factors in Figure 5 are interconnected. The effects of *demographic shifts* are well understood: overall population is aging, sometimes at an alarming rate. In 2025, the percentage of people older than 65 years in many developed economies is projected to be near or exceed 20 percent – 18.3 percent in North America, 22.6 percent in Western Europe and 29.2 percent in Japan.[15] This will not only affect pensions systems (with corresponding changes in legislation) but also insurance products, distribution and saturation. Such large demographic shifts automatically induce changes in the *availability of skills*, both front and back office. As one European executive put it, "finding talent will be the most decisive competitive parameter for insurers in the middle term."[16]

Last but not least, *new technologies* will force change by allowing enterprising insurers, as well as entrants from other industries, to introduce new offerings, upsetting the playing field. For example, Austrian insurer Uniqa recently introduced a product called "Safeline," which combines a usage-based motor insurance tariff with additional safety and risk protection features such as emergency calls and theft monitoring.[17] As we have seen in the T3 studies, such offerings can receive widespread acceptance, not only from people with low mileage, but across all demographic groups. While at first cherry-picking effects will be likely (attracting mainly lower risk drivers who under the current system pay too much for their motor insurance), in the long run other providers will be forced to react and adopt similar approaches or invent new ones to compensate.

Motor insurance has been the obvious playing field for innovative approaches based on new technologies, but others are possible and being contemplated. Uniqa has been looking at technologies similar to Safeline for areas like health, transport, household and general theft protection.[18] Any one of these will change the playing field, not only in Austria but internationally, as in the open services market of the European Union a "migration" of insurance customers is unavoidable. With miniaturization and wireless communication becoming ubiquitous, expect to see more of these new insurance ideas over the next few ears.

"When "Google" starts doing insurance business as an insurer, it will become forbidding."

– Executive, Japanese P&C Insurer

Customer equity versus customer value: Understanding the empowered customer

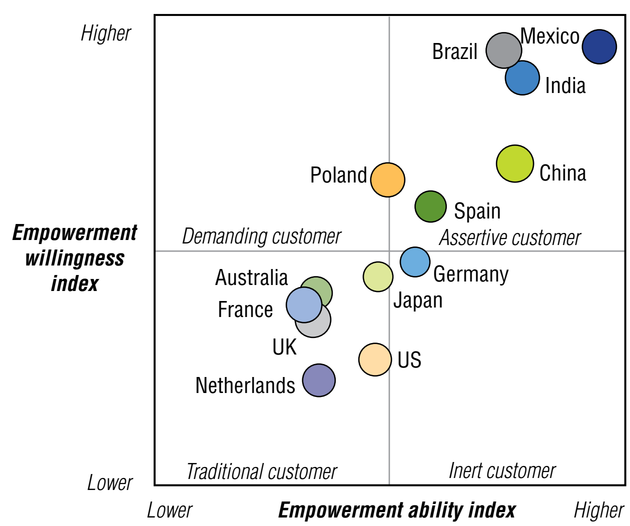
In the study, "Insurance 2020: Innovating beyond old models," insurance executives told us the customer of the future would be "active and informed", a trend we verified last year in "Trust, transparency and technology" (T3). This time, we wanted to go one step further: how can we measure how active and informed the insurance customer is?

To understand this, we used a concept we called customer empowerment: the degree to which an insurance, bank or other financial services customer takes charge of the relationship with his or her provider. We treated this as a two-dimensional variable. Empowerment ability measures how well they *can* take charge and empowerment willingness how much they *want to* take charge.[19] Figure 6 shows insurance customer empowerment by country.

More highly developed countries show a lower empowerment index than growth countries, both on the ability and the willingness score. This makes sense: countries with a long tradition of sophisticated financial services have "trained" their customer base toward more acceptance of the *status quo* – especially in the insurance industry where recognizable innovation is the exception rather than the norm.

For insurers, the important concept behind empowerment is not only in the overall numbers or their average distribution, but also in the question: "Do we have these data? In essence, do we know how empowered our customers are and want to be?" Empowerment ability measures factors like access to information and transactional capabilities, i.e., whether insurers allow customers to easily work with them. These factors are not entirely driven by the single insurer. Both providers on their own and the industry as a group can influence the level of empowerment ability. Low ability combined with a high willingness – i.e. the "demanding customer" – is a potentially dangerous mix for the industry. These consumers want to be active and informed, but external barriers, imagined or real, prevent them from reaching the top right quadrant (the "assertive customer"). In the developed economies in our survey, 15 percent of respondents fell into this "demanding" category. These are cherries to

FIGURE 6.
Consumer empowerment by country.



Source: IBM Institute for Business Value consumer survey, n=6,129.

Providers often overestimate the willingness of customers to pay for intangible value.

be picked by interlopers – if their demands are not met by their traditional providers, they will look for, and maybe find, substitutes.

Many insurers seem to realize that understanding customers is one of the keys to future success. In our survey of financial services providers, 54 percent of insurers mentioned client analytics as top investment priority in the non-IT area – 10 percentage points more than retail banks. Most of customer-related investment is planned to go to pure data analysis (52 percent), followed by improved delivery and specialized talent. For all this investment, insurers (and other financial services providers) are not very good at assessing their customers' preferences beyond product purchasing.

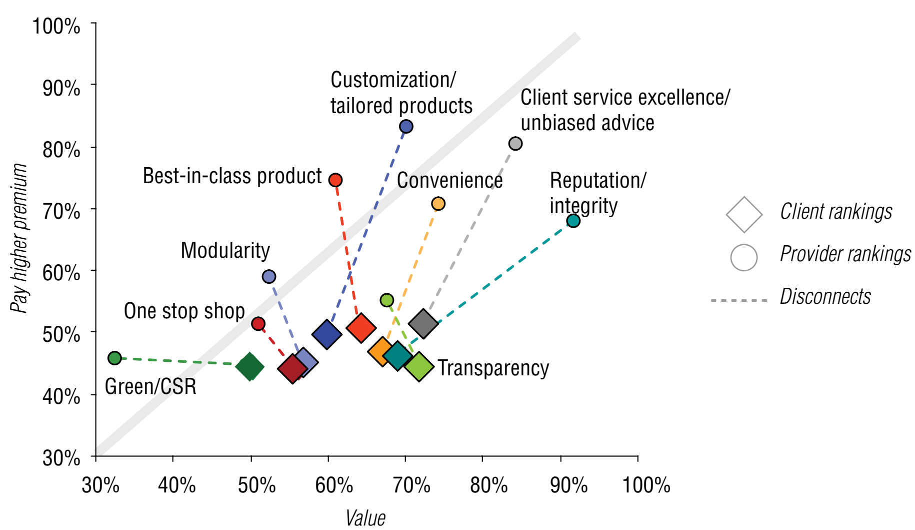
We asked insurance customers what they value in their dealing with insurance, and whether they would be willing to pay extra. Then we asked insurers for their assessment of what their customers would answer. Figure 7 shows the results: providers generally overestimate consumer willingness to pay for "intangible" value – sometimes by wide margins.

This type of analysis is helpful when determining investment priorities. The simple "what would they pay for?" question is the first step, but a serious customer equity or customer lifetime value analysis should involve more aspects of customer value, such as:

- What are customers' needs/motives?
- What are their expectations and experiences?
- What are the opportunity costs of not investing?[20]

Additionally, psychographic segmentations like the one we used in this research can help in answering where to invest and into which customers. "Convenience Desirers,"

FIGURE 7.
Real versus perceived value.



Source: IBM Institute for Business Value consumer survey, n=6,129.

for example, are, on average, willing to pay 6 percent higher annual premiums for the better quality of the intangibles shown in Figure 7, compared to only 1.5 percent for "Service Expectants." Of the segmentations we analyzed for this study, the psychographic segmentation produces the clearest distinctions regarding what customers are willing to pay for. Other segmentations, such as empowerment type, could be used to assign further weightings. "Inert customers" – which at first glance seem to be the ideal customer because they have little interest in becoming empowered despite the ability being there – actually are the ones willing to pay the least. "Assertive customers," on average, are willing to pay the most. Because of their empowerment, they feel more secure that their choice is correct and worth paying for.

Insights like these can allow insurers to draft realistic business cases – which should include measures for proving to consumers that they will actually receive the intangible value they are paying for, like transparency or modularity.

Looking forward

In our study "Insurance 2020: Innovating beyond old models", published in 2006, we explored the future trends of the insurance industry. Revisiting those results in our recent interviews with insurance executives, we found the four megatrends unchanged: Active and informed consumers – in the terms of this study, demanding and assertive consumers – will change the playing field by rewarding innovative approaches; new technologies will make it easier for interlopers to move into an increasingly virtualized insurance value chain; insurance products can and will be broken into smaller and smarter components with improved flexibility for customers and improved profitability for insurers; and last, but not least, regulation is likely to change on a global scale.[21]

With these trends as a basis, the current study findings point to some specific action points for insurers to work upon in the near to mid term:

- *Improve customer analytics*. With the financial crisis destroying so much wealth, we expect customers to increasingly scrutinize all financial providers that impact their money or assets. Good customer relationship management has always been about getting the right information to the right place at the right point in time. While the latter two are about smart processes and technology, "the right information" is the weak point for many insurers: it is not only about obtaining and analyzing data, but also converting the data into intelligent and efficient actions.
- *Improve flexibility and integration*. Steady growth and increased industry consolidation have lead to a multitude of cumbersome legacies in systems, processes and organizations. To be responsive – to changing regulation, demographics, innovation and competitive action – these legacies have to

be overcome. In various projects we have seen around the world, the use of componentization and multi-tier paradigms for back-end operations have been showing cost and efficiency benefits. Additionally, scale is not *per se* beneficial: with insurance business being so regional, it has to be accompanied by intelligent integration to reap the benefits of going global.

- *Specialize intelligently*. One size does not fit all, and customers care less about one-stop shops and more about proficiency than conventional wisdom generally allows for. For insurers and financial services providers in general, this means that a clear profile for each service line is important. "Be easy to do business with" is the key here – not only for full service offerings, but for all sub-brands.

Of course, no single recipe is likely to work – in the end, having a successful place in the competitive insurance landscape of the future is about finding the right weights and balancing the scales.

About the authors

Christian Bieck is the global leader of the IBM Institute for Business Value Insurance practice of IBM Global Business Services. Christian is an economist by training; he worked in various roles in the insurance industry in Europe before joining IBM as a process consultant and researcher. Christian is a frequent speaker on thought leadership and innovation at insurance events and workshops. He authored various papers and POVs on insurance trends and implications, both for the IBM Institute for Business Value and for insurance industry publications internationally; he can be reached at *christian.bieck@de.ibm.com*.

David Notestein is the finance sector leader for the IBM Institute for Business Value. David is an engineer and financial analyst by training; he has worked in various senior management roles in the finance sector before joining IBM. David advises individual companies and speaks on leading business practices and key issues facing businesses; he can be reached at *danotes@us.ibm.com*.

Contributor

Wendy Feller, Associate Partner, IBM Global Business Services Strategy

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[19] Note: Because the analysis is based on a consumer survey, both parts of the index are subjective – this means that we did not (and cannot) measure objective empowerment, but rather the consumers' subjective *feeling* of ability and willingness to be empowered.

[20] See Peter Maas and Albert Graf: "Customer Value Analysis in the Financial Services Industry", Working Papers on Risk Management and Insurance, 2007.

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Somers, NY 10589
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