2012 US Auto Insurance Study[SM]

MANAGEMENT DISCUSSION

June 2012

Insurance Practice

Introduction

Since 2000, J.D. Power and Associates has annually surveyed personal auto insurance customers in the US marketplace, benchmarking the strengths and weaknesses of the highest-ranked insurers in terms of satisfying customer expectations. Throughout the years, many companies in the insurance industry have used J.D. Power's data to benchmark their competitive performance in customer satisfaction and to better understand how improvements lead to stronger financial performance. J.D. Power first examined the relationship between highly rated service experience and financial performance in 2005, at a time when the US economy had experienced almost 5 years of strong performance. In the ensuing years, the US economy suffered a major recession, and the insurance industry endured a number of ratings downgrades and received a couple of government bailouts. Today, some emerging trends are dramatically reshaping customer expectations in the personal auto insurance market—consumer confidence has yet to recover to pre-recession levels, new technologies provide expanded forms of communication, and the expansion of Gen Y entering the insurance market.

The *J.D. Power and Associates 2012 US Auto Insurance Study*SM measures customer satisfaction regarding each customer "touch point" of their interaction with their insurer, including the policy offerings, price, billing and payment, customer service interactions, and claims experiences. Over time, these touch points consistently show that the day-to-day policy service interactions most influence how customers rate their overall experience with their insurer, and hence their likelihood to both renew their policy and recommend their insurer to others. However, the drivers of satisfaction have been gradually changing over time. The impact is profound when comparing the 2012 drivers of satisfaction with those of the pre-recession 2007 index model. In 2007, the service experience delivered by Local agents was the dominant driver of insurance customers' overall satisfaction. In the 2012 model, the Local agent factor has declined to fourth-most important, as more customers buy through the Direct channel, and even those with a Local agent are notably prone to interact with their insurer via multiple channels. Conversely, Price has increased from being the fourth-most-important driver of satisfaction in 2007 to the most important driver in 2012.

Technology has influenced these changes, as insurers have responded to customer demand by expanding Internet-enabled alternatives for interaction. An expansion of self-service options offered to meet the rapid growth in demand has indirectly resulted in the erosion of the importance of personal contact in establishing a relationship between customers and their agency or service representative. While technology has changed customers' interactions, the current economic conditions and consumer confidence—which continues to lag pre-recession levels—are likely influencing customers' perception of value for price. While the economy is showing stuttering signs of recovery, growth in income has slowed and savings are down, indicating consumers have less income for expenses. Customer perceptions of the prices they pay for goods and services are really a statement about the perception of value. As such, the insurance market has profoundly increased the volume of advertising messaging regarding price competitiveness, product features, and, most critically, discounts—all of which reinforce the product value perception among insurance customers.

Lastly, another driver of the change that impacts both technology adoption and an increased focus on price is the demographic shift of Gen Y[1] customers into the personal insurance marketplace. As the share of the Gen Y driving-age population has increased, the preferences and service expectations of these customers have accelerated the shift in overall industry service priorities. Gen Y customers tend to be more price sensitive, showing a more adverse reaction to price increases and a stronger willingness to shop and switch carriers. They also lead the way in the emerging trend of self-service via the Web and in adopting other digital alternatives. While a majority of Gen Y auto insureds still purchase their policies through an agent, they tend

[1] J.D. Power and Associates defines generational cohorts as Pre-Boomers (born 1945 and earlier); Boomers (born 1946-1964); Generation X (born 1965-1976); and Generation Y (born 1977-1994).

to prefer seeking subsequent policy services via their insurer's website, which presents a unique challenge for agents, who struggle to build a personal relationship through regular interaction with these customers.

The balance of this management discussion will further explore the shifting service channel behaviors in the personal auto insurance marketplace, as well as the impact they have on customer satisfaction. Most significantly, this management discussion will revisit the financial impact analysis first introduced in 2005 and demonstrate that while what is important to customers today has changed, the benefits to insurers that successfully meet these new service demands not only have not changed, but remain strong: higher policy retention, more policy referrals, and improved cross-sell capability and pricing power.

Evolving Drivers of Satisfaction

The J.D. Power and Associates Customer Satisfaction Index model for the *US Auto Insurance Study* segments the customer experience into several factors, each representing a distinct part of the experience and together encompassing the entire relationship between the customer and their insurer. Each year, J.D. Power conducts a statistical analysis to determine if there are meaningful changes in the underlying impact weights, or drivers of satisfaction, used to calculate the overall index. In each of the past 6 years, this analysis resulted in slight variations to the model, and the impact weights have been restated several times throughout this period. A few trends that have emerged during the past 6 years are the growing importance of the Price factor, which measures satisfaction with the coverage customers are paying for, and the lower importance of the Interaction factor, with declining emphasis on the agent and higher importance for direct interactions through websites and call centers. While these trends have shown subtle movement each year, in aggregate the differences represent a notable shift when comparing the 2012 model with that of 2007.

Customer Satisfaction Index Model: Drivers of Satisfaction

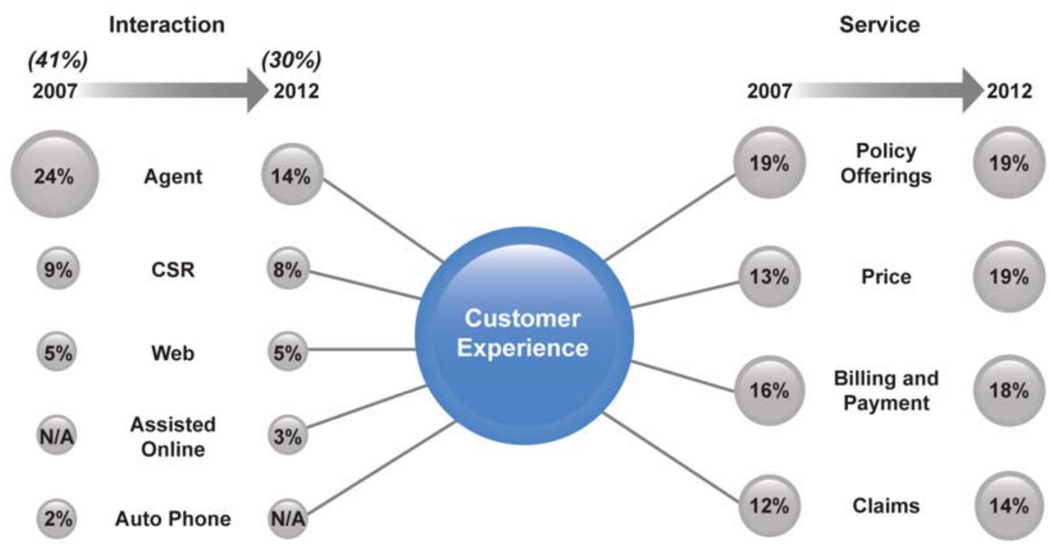


Figure MD1

Figure MD1 illustrates an average total index model for the industry. The most notable change is in the Agent sub-factor in Interaction, which has declined by 10 percentage points, and moves from having been the most important driver of satisfaction in 2007 to fourth-most important in 2012. The Price factor has increased by 6 percentage points during this same time frame. Due to the declining use of automated phone systems as a sole method of interaction, the sub-factor has been replaced in the 2012 index model with Assisted Online to reflect the growing trend of increasing utilization of email and online chat directly with the insurer.

Generational Differences in Drivers of Satisfaction

As noted in the Introduction, Gen Y consumers are embracing self-service channels at a higher rate than in the past and thus influencing some of the shifts in the overall drivers of satisfaction. Several differences are evident when comparing the impact weights between the generational cohorts. The importance weights for Web interactions and Assisted Online have increased, while the weight for the Agent sub-factor in the Interaction factor has declined. This is partially due to an increased number of customers using the Web and new technologies to interact with their insurer, as well as an increased importance of using these channels. In contrast, the Claims factor has a much lower weight among Gen Y customers, primarily due to these customers having a shorter tenure with their insurer and less likelihood of having filed a claim compared with customers in the other age cohorts. The lower weight of the Claims factor among Gen Y customers is consequently redistributed to other factors, such as Policy Offerings and Price.

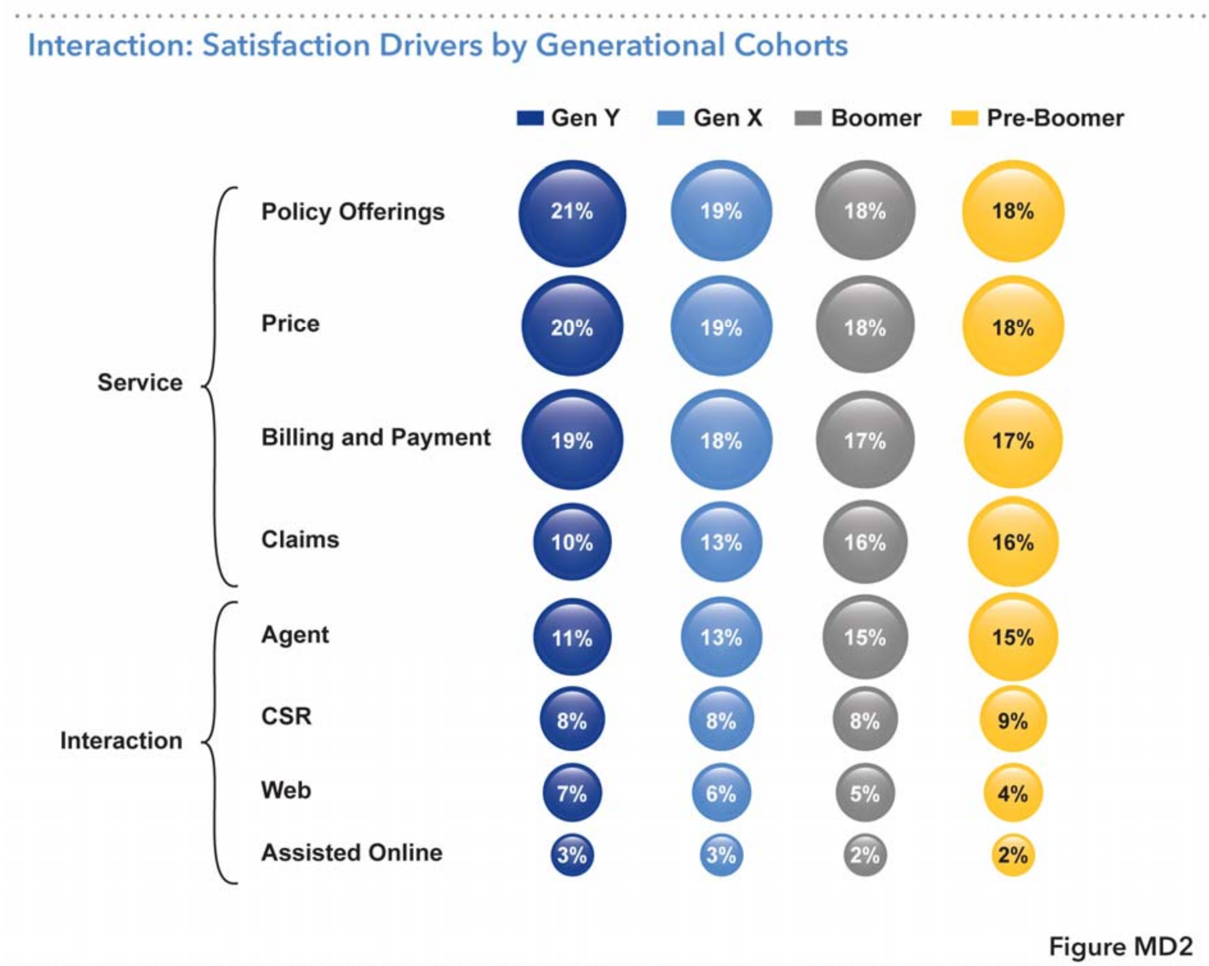


Figure MD2

Comparing the index model by generation identifies how different the customer experiences among Gen Y customers have become, and will likely continue to evolve in the future as even more consumers in this generation enter the personal auto insurance market. In 2007, Gen Y customers accounted for 12% of all auto insurance buyers; in 2012, that proportion has doubled to 24%. The claims experience of Gen Y customers will likely increase over time, which will result in that factor having a higher importance weight, but the differences in interactions that reflect behavioral preferences may not change over time.

Gen Y customers have clearly shown a preference toward interacting online. Even among those who purchase through an agent, their preference is to conduct day-to-day interactions online—such as billing inquiries, making payments, or gathering information. Only when seeking help regarding coverage or premiums, e.g., a price change, obtaining a quote, or changes to their policy, do these younger customers behave like their older counterparts in contacting their agent. Furthermore, among customers who utilize multiple contact channels to resolve an issue, 40% of Gen Y customers begin online, further underscoring their preference to seek answers to their questions via this channel. In contrast, the most frequent starting point for Boomers, who have used multiple channels to resolve an issue, is their agent (40%).

Among customers who have interacted with their insurer in the past 12 months, Gen Y customers not only use insurer websites at a higher rate than do customers in other age cohorts, but also visit their insurer's website at a higher rate than any other contact method. Insurer websites have been the predominant service channel among this age group for several years now.

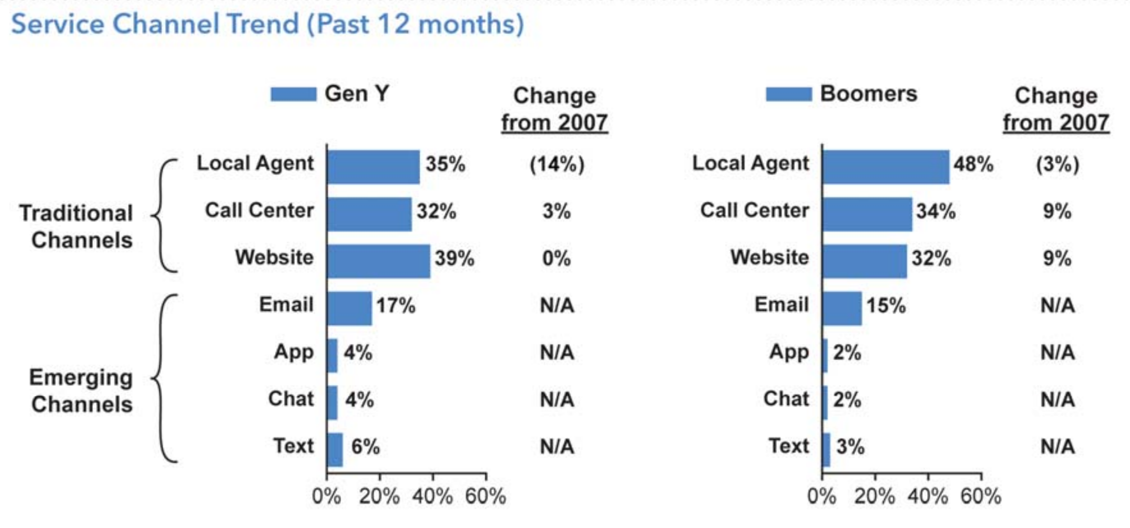


Figure MD3

Although Gen Y customers have the highest percentage of Internet usage, Website is a prevalent service channel among customers in every generation and represents an increasingly sizeable share of customers' experience in interacting with their insurer. The Local Agent channel is still a dominant driver of overall Interaction for all age cohorts, suggesting that customers of all ages are not ready to abandon their agent entirely. (Figure MD2) However, the role of the agent is certainly diminishing among the Gen Y cohort, as the frequency of interaction has declined 14 percentage points during the past 6 years, which has influenced the overall shifts in the index model.

Digital Interactions Impact Importance Weights

As self-service channels continue to enable customers to accomplish more service interactions without speaking to a person, they increasingly have opted instead to exclusively interact through digital means. The number of customers who have only interacted via digital channels in the past 12 months has nearly doubled in size, compared with 2007, and now represent approximately one in six customers. This is primarily driven by Gen Y customers, among whom more than 20% of recent interactions are digital only. As this trend continues, the value of offering a personal level of service may continue to be challenged because digital interactions will be more of the norm; furthermore, with the human element removed from the interaction, the focus of importance will increasing shift to the Price and Billing and Payment factors.

Figure MD4 shows the relative importance of each factor based on how customers have interacted with their insurer during the past 12 months. Among customers who spoke with a person (agent or call center CSR) and also interacted through a digital method (i.e., website, email, or online chat), the Interaction factor represents a notably larger importance weight (38%). In contrast, among customers who have only interacted through digital channels, the importance of those interactions is only 30% of the model, and is offset by higher importance weights for both the Price and Billing and Payment factors.

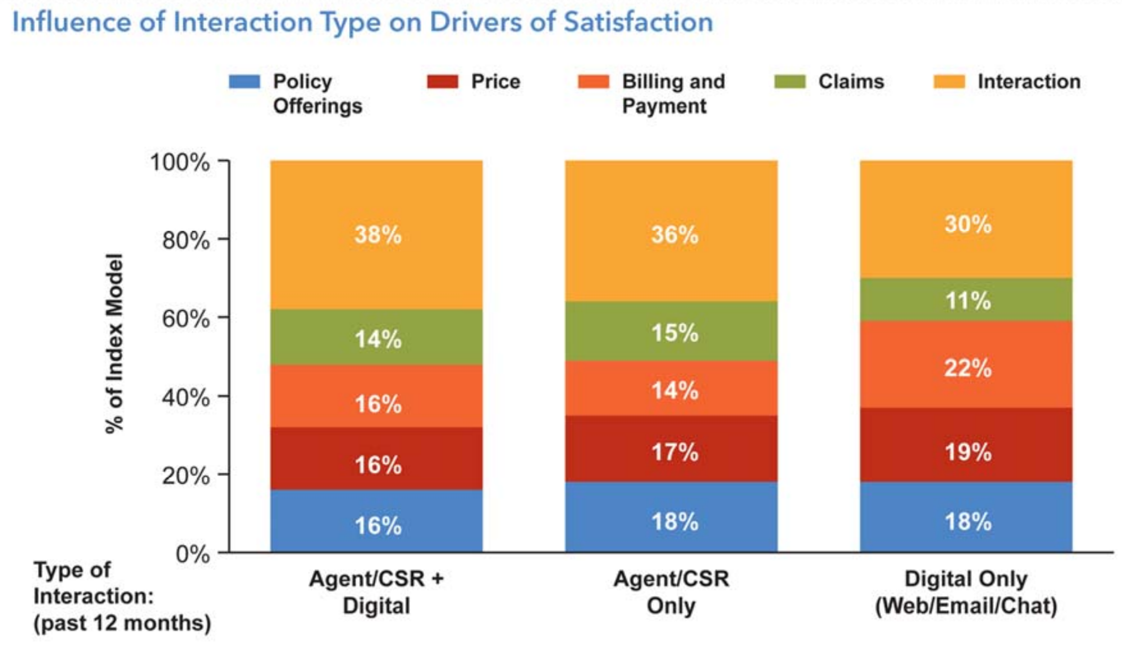


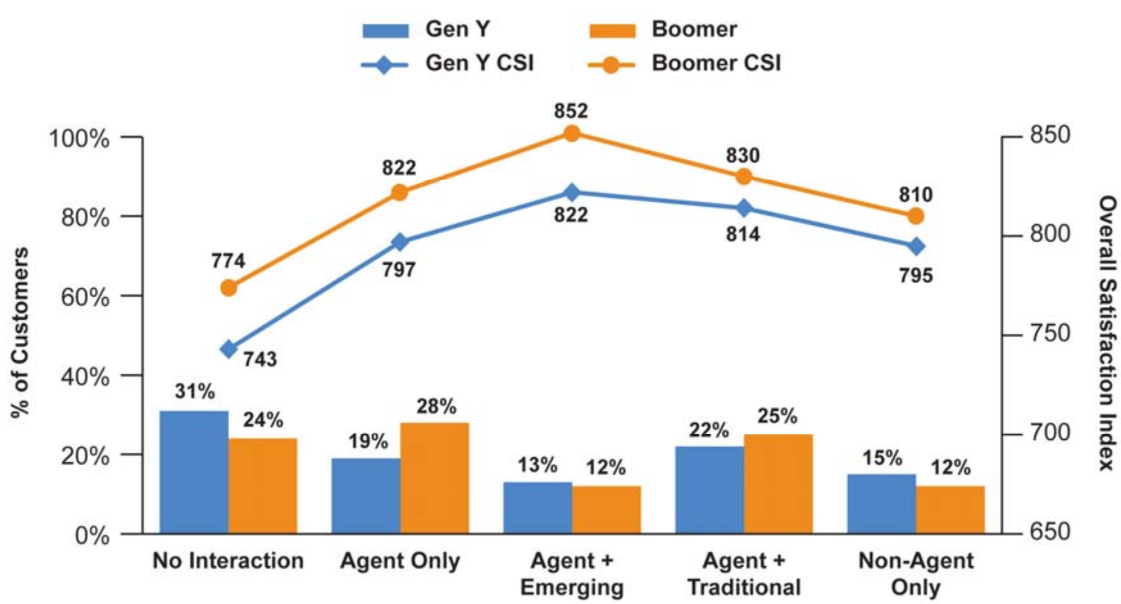
Figure MD4

Although digital-only interactions are a growing trend and are an indicator of how the marketplace and customer expectations will continue to evolve, they still represent only a portion of all interactions. The challenge for insurers is to make these offerings available to customers, as the key to maintaining a competitive advantage and satisfied customers is serving them through the contact channels they prefer.

While agents still represent an important role in customer interaction, online and other digital methods are being utilized more as complementary service channels—and customers are responding favorably toward having these options available. Figure MD5 shows a comparison of Gen Y and Boomer agent-serviced customers by the type of interactions within the past 12 months and the impact on satisfaction based on the different channels of interaction utilized.

Satisfaction is significantly higher among both age cohorts when they deal exclusively with their agent for all servicing needs, compared with customers who have had no interaction in the past 12 months. However, fewer than 20% of Gen Y customers exclusively interact with their agent, while 50% have utilized some other channel, either in additional to their agent or in place of their agent. Satisfaction is highest among a small but growing segment of customers who interact with their insurer both through the Agent and Emerging channels. This represents a significant competitive opportunity for those insurers and their agents that fully embrace customers' adoption of contact via the Emerging channels, which includes email, text, and smartphone apps.

2012: Channel Usage Among Agent-Serviced Customers



Note: Data excludes "Other".

Figure MD5

Boomers have a higher rate of dealing exclusively with their agent, but even this generational cohort interacts with their insurer through additional methods at a similar rate as Gen Y, and similarly, has higher satisfaction as do those customers using other contact methods in addition to their agent.

With an increasing number of customers selecting different channels, depending on their reason for contact, channel blending is becoming the norm for both Agency and Direct writers, whether customers use discrete channels for individual needs or multiple channels for a single inquiry. In either method, customers have grown to expect they will have the ability to contact their insurer via every channel their insurer provides and that all areas of the company are effectively talking to each other and sharing customer-related information. Insurers that can effectively leverage these technologies will likely positively impact customers' overall satisfaction, and hence their likelihood to both renew their policy and recommend their insurer to others.

The Financial Benefits of Meeting or Exceeding Expectations

Since 2005, the *US Auto Insurance Study* has demonstrated the value of improved satisfaction relative to three key measures of financial performance for an insurer's entire book of business:

- Increased customer retention
- Increased growth and reduced acquisition costs
- Lower price elasticity for satisfied customers

Insurers that provide a highly satisfying customer experience benefit from higher customer retention, reduced costs in acquiring new customers, and more word of mouth referrals than do insurers that deliver less satisfying experiences to their customers. This relationship between satisfaction and renewals and recommendations are shown in the charts below. Figure MD6 plots the mean satisfaction index score and actual retention as measured through screening the switching behaviors of 150,000 households, with each data point in the graphic depicting the average performance for the insurance companies profiled in this year's study. Retention rates are notably higher for brands that deliver a highly satisfying experience.

The relationship is even stronger when comparing stated intent to recommend the insurer. (Figure MD7) The highest-rated insurer achieves a proportion of customer-stated intent to recommend well above 70%, compared with the lowest-rated insurers, among whom less than 25% of customers state they will recommend their insurer. Such positive recommendations may lead to lower acquisition costs, as the effort to recruit these prospects is lessened by word of mouth advertising. Furthermore, insurers with a higher proportion of satisfied customers will ultimately have a more stable book of business that is not only less vulnerable to competitors' marketing efforts, but also provides a relatively predicable source of future premiums.

Overall Satisfaction and Retention

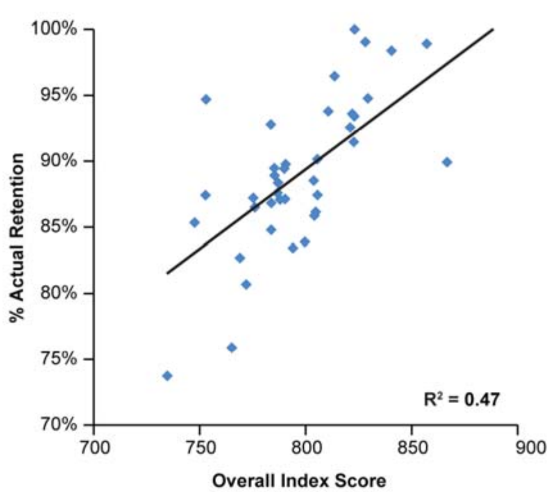


Figure MD6

Overall Satisfaction and Intent to Recommend

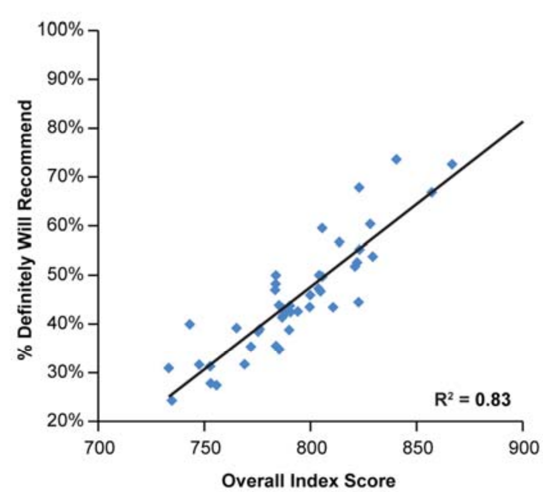


Figure MD7

Pricing Power

While rates and, hence, premiums are constrained by regulators, market pressures are also a major constraint. For a protracted period, average premiums have been soft, both because of lower claims costs and aggressive market competition. However, that has changed during the past 12 months, as numerous insurers have initiated rate filings to improve underwriting performance. This presents a significant challenge to policy retention, as the average customer is significantly less satisfied at renewal if their premium increases by more than $50 with no apparent change in coverage. However, building a relationship with customers that is founded on high customer service experience has proven to be a successful tactic in seeking to both take rate and avoid policy attrition. Simply put, those insurers that currently enjoy a book of highly satisfied customers are much better able to increase rates without losing high-value customers than their counterparts with average or below-average satisfaction.

The survey for the 2012 study asked respondents what amount of reduced premium it would take for them to consider changing insurers. To analyze this, insurers were grouped into satisfaction tiers (high, defined as a satisfaction score of 818 and higher, medium, 778-817 in score and low, or 777 or lower) to assess each group's vulnerability to defection based on price. Nearly half (45%) of customers insured with high-satisfaction insurers say they would not switch for any price, compared with only 21% of customers insured with low-satisfaction insurers.

Price Sensitivity by Satisfaction Segment

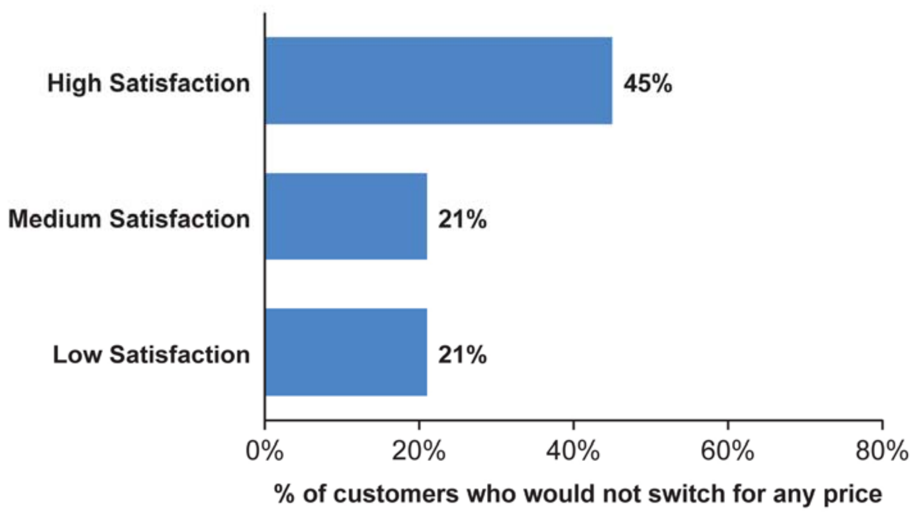


Figure MD8

Customers of low-satisfaction insurers are often "sold" based on price, to a greater extent than are those of high-satisfaction insurers. Combined with the greater influence of other, non-price-related factors, the low-satisfaction insurers are more reliant on low price than are their high-satisfaction competitors. If low customer satisfaction requires a company to sell auto insurance based on price, and implies a poor perception of value received, then the pressure to keep prices low is greatest on those companies. High-satisfaction insurers should therefore have more market flexibility to charge higher prices for the value they deliver to their customers.

Conclusions

As customer preferences and interaction behaviors continue to evolve, insurers must be prepared to adjust their service strategies to keep pace with those changing preferences. Insurance customers today can no longer be segmented as either Agent or Direct customers, as evidenced by their preferences to interact via not one, but multiple channels, depending on need. While each insurer's book of business varies both geographically and demographically, all insurers face the reality that customer expectations are being reshaped by market forces beyond their control—whether through the emergence of devices, such as the iPhone and iPad and platforms such as Twitter or Facebook, or through changing servicing dynamics being introduced in other industries. Every insurer must recognize that adapting to the changing service –channel preferences is a decision of necessity that will need to be made in the not-too-distant future.

Ultimately, it all comes down to customer choice—today that choice is rapidly expanding to include a variety of new self-service tools and interfaces. During the past decade, the industry has shifted from redirecting customers to their sales channel for service to migrating them to the Internet for cost efficiencies, and, more recently, opting to give customers the freedom to choose how they want to interact with their insurer. One positive outcome of this freedom of choice is higher customer satisfaction, which may lead many satisfied customers to blog, tweet, or otherwise message to friends and colleagues regarding their positive auto insurance experiences, and may shape future purchase decisions.

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